WHO'S IN YOUR WALLET: EXAMINING HOW WASHINGTON RED TAPE IMPAIRS ECONOMIC FREEDOM

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

APRIL 8, 2014

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WHO'S IN YOUR WALLET: EXAMINING HOW WASHINGTON RED TAPE IMPAIRS ECONOMIC FREEDOM

Tuesday, April 8, 2014

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, King, Royce, Capito, Garrett, Neugebauer, McHenry, Pearce, Posey, Fitzpatrick, Westmoreland, Luetkemeyer, Huizenga, Duffy, Hurt, Grimm, Stivers, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus; Waters, Maloney, Sherman, Meeks, Clay, Scott, Green, Ellison, Himes, Peters, Sewell, Foster, Kildee, Murphy, Delaney, Sinema, Beatty, Heck, and Horsford.

Chairman Hensarling. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

Before we begin our proceedings, I would like to take a moment and recognize the newest member of the House Financial Services Committee, Congressman Steven Horsford, the freshman Representative from Nevada's newly created 4th District.

I was informed that before running for office, Mr. Horsford was the CEO of the Culinary Academy of Las Vegas. So I wish to inform my colleague that it is a longstanding tradition of this committee that the newest member bring culinary delights for the rest of the members' enjoyment. We look forward to what you will bring to our next hearing.

We assume you will bring great policy and intellectual offerings as well as your culinary offerings to the committee. Our colleague served in the Nevada legislature from 2004 to 2012, where he became Nevada's youngest and first African-American State Senate Majority Leader.

I, on behalf of all of the committee, welcome him to the committee, and I would now like to recognize the ranking member out of order for 1 minute to welcome our new colleague, as well.

Ms. Waters. Thank you very much, Mr. Chairman. And of course, you have said much of what I was going to say.

However, I am very happy to welcome Mr. Steven Horsford as the newest member of the House Financial Services Committee. Mr. Horsford represents Nevada's newly created 4th Congressional

District. And again, I think it is important to note that he is the first African-American to serve in Nevada's Federal delegation.

Before his election to Congress, Congressman Horsford served in the Nevada State Senate, where he became Nevada's youngest and first African-American State Senate Majority Leader. He also served as Chair of the Senate Committee on Finance. During his time at the Nevada legislature, Mr. Horsford built a reputation as a bipartisan legislator and a strong advocate for middle-class and working families.

Then-Senator Horsford worked on legislation that slowed down the rate of foreclosures in Nevada, increased transparency and due diligence in the foreclosure filing process and helped reform unfair lending practices. He comes to us with demonstrated leadership capabilities, real-world knowledge of today's labor market, and a heart for serving middle-class and working-class families. He will be a valuable addition to this committee and I look forward to working with him.

I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

I am now happy to yield, out of order, 1 minute to the gentleman from Nevada to tell us what he is cooking for lunch. The gentleman is recognized for 1 minute.

Mr. HORSFORD. Thank you, Mr. Chairman, and Ranking Member Waters, for your kind welcome and your introduction. It is my honor to join the Committee on Financial Services and I am proud to represent the people of Nevada's 4th Congressional District.

Nevada, as many of you know, was hit particularly hard during our economic downturn, and although we have made great strides in rebounding, and our home values are continuing to increase, we still have a long way to go. Southern Nevada remains the most unstable housing market in the country, and the root of many problems facing Nevada families is that, unfortunately, many of them no longer feel secure in their homes.

So I am grateful for the opportunity to serve on this committee and I look forward to working with my colleagues on both sides of the aisle to pass meaningful legislation that addresses some of the hardest-hit communities in our Nation, and while my previous career was in culinary arts and helping train and employ people in careers in the hospitality industry, Mr. Chairman, I was not a culinarian.

I cannot cook. So I will have to cater out. But if we can pass some meaningful legislation, I would be happy to make sure that contribution is made.

Thank you. I yield back my time.

Chairman HENSARLING. We will make sure the Member is informed of all relevant ethics rules. The gentleman yields back.

Perhaps we can all make him feel welcome.

[applause]

Chairman HENSARLING. Our hearing today is entitled, "Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

I now recognize myself for 4 minutes to give an opening statement.

Last Friday, the House debated a rather simple, common-sense bill requiring the Congressional Budget Office to produce long-term macroeconomic analysis of proposed legislation. It was strongly opposed by House Democrats.

If this bill had been law just a few years ago, Members would not have had to pass Obamacare to find out what is in it. They and the public would have known before the fact instead of after that, according to the Congressional Budget Office, Obamacare will result in 2.5 million fewer jobs. Information like this should not be swept under the rug.

Regrettably, something similar happened in this committee just last week. The Oversight and Investigations Subcommittee received testimony from a high-ranking CFPB whistleblower concerning serious allegations of discrimination and retaliation at the Bureau. Her testimony was corroborated by the CFPB's own independent investigator, and both testified as to many other CFPB employees who have lodged these same allegations.

What was the response from the Democratic leadership on the committee? They demanded the hearing be cancelled. In other words, the matter would regrettably be swept under the rug, hidden from public view, ignored.

Likewise, many Democrats have harshly criticized cost-benefit analysis, looking at the pluses and minuses of the rule, the impact on jobs, asking the question of whether a rule on balance helps or harms hardworking, struggling American families.

The ranking member, for example, declared that legislation requiring cost-benefit analysis is dangerous. I believe what is dangerous is sweeping under the rug the mounting evidence that many rules promulgated under Dodd-Frank and its ideological precursor, the CARD Act, are harming consumers.

The Federal Reserve now reports that one-third of Black and Hispanic borrowers would be hurt by the qualified mortgage (QM) rule. In the American Bankers Association's most recent lending survey of banks, one-third of respondents said they plan to reduce their mortgage lending only to QM loans. Perhaps that is why QM is rapidly becoming known as the "quitting mortgages" rule.

The FDIC has reported that it has become more difficult for lower-income Americans to access banking services because checking and savings account fees have gone up. Almost one-half of banks that previously offered free checking no longer do so.

In a recent survey of banks regarding CFPB's remittance rule, the ABA reported that 42 percent will now increase fees, and 18 percent plan to stop offering the services altogether. Forty percent of lower-income families have reported that their credit cards have been cancelled, not renewed, or their limits reduced since the passage of the CARD Act.

Clearly, the evidence continues to mount and cannot be conveniently swept under the rug. It is time for everyone to take off partisan blinders and acknowledge the truth that Washington regulators aren't always right and more red tape is not always the solution to every problem. It is time to hold Washington accountable.

Frequently, I receive letters or correspondence like the following from a banker in Central Texas, who I think sums up the challenges well. He wrote, "We have provided fair, honest, and competi-

tively priced loans and home mortgages in our market for as long as I have been with the bank. And for the record, we have not had a home foreclosure in over 25 years.

"Currently, our ability to cope with the regulatory burden is at a critical stage. We are spending an unprecedented amount of time and resources trying to understand this process as the various agencies continue to draft new rules and guidance at will. Just a new regulation here and there and now consumer lending has become a compliance nightmare.

"There is no time left to take care of our customers or develop new relationships because all of our team is busy working on compliance issues. The spirit of the law no longer exists as the regulatory environment has changed from a helpful and supervisory approach to the gotcha attitude where only the slightest issue can bring instant criticism to your bank.

"Reluctantly, we are working to downsize our consumer lending program, especially in the small loan area. Also, due to the massive new regulatory focus on mortgage loans, we have suspended our home lending activities as of this month. This is not good news for our community, but we can no longer comply with the massive burden."

I think the letter speaks for itself. Regrettably, I receive many such letters, thus the subject of our hearing today.

I now yield 5 minutes to the ranking member for an opening statement.

Ms. WATERS. Thank you very much. Mr. Chairman, before I proceed with my remarks I must set the record straight and I must share with this committee that the Democrats did not ask for a cancellation of the hearing.

We asked that the hearing be cancelled because, in fact, you had set out to hold the hearing based on a report that was aired in the American Banker. You changed the makeup of that hearing and you went in another direction with one individual.

So when the CFPB decided they would not come because you had changed the hearing, we agreed with that, but we made the young lady, the lawyer, Angela Martin, very welcome, and I yielded my time to her so she could tell us more about the discrimination in the CFPB that she was claiming was being perpetrated by White males against African-Americans and others.

We welcome that information and we welcome your newfound interest in doing something about discrimination. We think that this is a healthy direction for your side of the aisle and we are looking forward to a hearing that will be organized in regular order to deal with these issues.

Furthermore, let me also mention that your concern about African-Americans and others being able to access mortgages under the QM rules, you need to know that one-third of banks have said they are satisfied with what has happened with QM in the way that the Consumer Financial Protection Bureau has helped to work out some of the problems, and one-third of the banks will now be making loans.

With that, I will proceed with my statement.

Just before Congress is set to leave town for a 2-week congressional recess, here we are again attacking regulators for their ef-

forts to repair the damage caused by the worst financial crisis since the Great Depression. This hearing, in my estimation, is nothing more than the latest chance for the Majority to air its ideologically-driven deregulatory agenda.

And it is a continuation of the Republican quest for extreme and unreasonable cost-benefit requirements, which do nothing more than undercut the ability of our regulators to do their jobs. How quickly my colleagues on the other side of the aisle have forgotten the loss of millions of American jobs and trillions of dollars of household wealth caused by inadequate regulation.

Mr. Chairman, the simple fact is that the Majority's cost-benefit requirements would impose additional costs on our regulators and expand government bureaucracy.

I find it ironic that we are participating in a hearing to examine so-called government red tape while many of my Republican colleagues are pushing measures that would only serve to increase it. It is unfortunate that this committee continues to consider these measures, which are becoming a not-so-veiled effort to roll back the significant accomplishments of the Dodd-Frank Wall Street Reform Act while ignoring a number of important policy matters that need our attention now.

We know the crisis was caused by dramatic failures of corporate governance and risk management at large, globally interconnected financial firms. We also know that excessive borrowing, risky investments, and a lack of transparency throughout the financial system put us on the path to crisis.

Although Washington had a role to play, it certainly was not because regulators erred on the side of overregulation. Despite their collective failure to see the crisis coming before it was too late, the financial regulatory agencies represented before us today should be commended for their effort that has already put our financial system on more stable footing. Regulators have made important progress by enhancing risk-monitoring and heightening capital standards at the largest and most complex banks and nonbank financial companies.

They have also increased cooperation and information-sharing among regulators of banks and nonbank financial companies, and they have enhanced the transparency and protections afforded to consumers and investors. Our regulators have also taken action to ease the regulatory burden for small banks and financial institutions by providing targeted relief.

I am looking forward to what the witnesses will say about actions to continue helping these small and community-based entities. As the number of legislative days continue to dwindle, I certainly hope that we can come together on important issues that merit our serious attention. Rather than accusing Washington of restricting economic freedom, we should be taking up bills that grow our economy and create good jobs for U.S. workers.

Mr. Chairman, this includes reauthorizing the export-import bank and extending the terrorism risk insurance program. Acting on these important measures now is imperative to ensure businesses have the certainty they need to invest in the economy. They both create and sustain American jobs and have widespread bipar-

tisan support, including a number of Republican members of this committee.

These issues desperately need our attention, and while we know they need to be addressed very soon, this committee has thus far simply refused to do so.

I thank you, and I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentlelady from West Virginia, Mrs. Capito, the chairwoman of our Financial Institutions and Consumer Credit Subcommittee, for 2 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman.

I would like to thank the witnesses for being here today.

The topic for our hearing today is how regulations emanating from Washington are affecting Main Street. This has been a common theme in the Financial Institutions and Consumer Credit Subcommittee over the past year.

In past hearings, we have heard significant concerns from community bankers and credit unions about how new regulations are removing a significant amount of discretion from underwriting consumer credit. One of the main issues we focused on are the mortgage rules that the CFPB issued last January, that went into effect this year.

These rules will have a tremendous impact on the Nation's mortgage market, and I feel the consumers who are most impacted by them and stand to lose are the low- to moderate-income borrowers. The hearings we have had on these mortgage rules have highlighted the importance of allowing lenders to have a tremendous amount of flexibility in determining a borrower's ability to repay.

We have learned about several programs that have allowed low-income borrowers, who otherwise would not be able to realize the dream of home ownership, to purchase their own home. In my home State of West Virginia, I have talked extensively with bankers who work with low-income borrowers to structure tailored products that would help them purchase the home. And in many, lenders have longstanding relationships with the clients that they serve.

They use these relationships and their local knowledge to extend credit to borrowers who might otherwise not qualify. Thanks to their efforts, many low-income borrowers in my State now own homes and are working towards greater financial flexibility. Unfortunately, the CFPB rules are bringing many of these programs to an end.

Many of the institutions that shared the success of these programs targeted to low- or moderate-income borrowers also shared significant concerns about the one-size-fits-all nature of the CFPB mortgage rules. This could be a huge problem for rural communities like those I represent in West Virginia. I have already heard concerns from bankers and individuals in my State that low-income borrowers simply will not be able to get a mortgage if they do not fit this qualified mortgage criteria.

Unfortunately, this Washington-knows-best approach is not limited to the mortgage market. The agencies before this committee have also taken action to limit the availability of consumer choice

in other ways. Many of the financial institutions that offer short-term loan products have now exited the business.

I yield back to the Chair.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, for 2 minutes.

Mrs. MALONEY. Thank you. I have a great respect for the chairman, but I must take issue with his statement that the CARD Act, the Credit Card Reform Act, hurts consumers. There have been two celebrated independent reports: one from the Pew Foundation that said this bill alone saved consumers a whopping $10 billion a year; and more recently, a report from three major universities, one of which was New York University in my district, which said that this bill saved consumers $20 billion a year. I fail to understand how keeping money in consumers' pockets hurts them.

What the bill basically did is that it stopped unfair, deceptive, and anticompetitive practices. The regulators themselves have endorsed it. The Fed came out with a rule that was practically totally similar to it, thereby showing that it did not hurt the industry or the overall economy, and the regulators tell me that the number of complaints on credit cards is now practically nonexistent.

The industry itself tells me that the number of complaints that they have to deal with are practically nonexistent. So I would say a bill that helps consumers is certainly not one that hurts them. And with all due respect, you are entitled, certainly, to your own impressions, but not your own facts.

And if there is a disagreement on these issues I would really hope that the chairman would have a hearing on it. Let's call in the Pew Foundation and the academics. Many consumer groups have given numerous awards to the bill for what it has done for the overall economy and in helping. It is a relief program, a stimulus program for consumers, keeping their money in their own pockets by stopping unfair and abusive practices.

I would call that a success. My time has expired.

I ask unanimous consent to put my opening statement that I prepared into the record.

Chairman HENSARLING. Without objection, it is so ordered.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets and GSEs Subcommittee, for 1 minute.

Mr. GARRETT. I thank the chairman for holding this very important and timely hearing today. These oversight hearings with the banking agencies are really much needed, and it is my hope that they will happen more frequently.

Having these hearings and requiring the regulators to come here and take and then answer some of the tough questions may be the only way we can ensure that they retain any level of accountability to Congress. Dodd-Frank bestowed almost limitless powers to the banking regulators, and especially to the Fed.

Unfortunately, all of these agencies continue to operate with little, if any, accountability. So instead of technocrats simply implementing the directives given them by Congress, these banking agencies now operate as policymakers on steroids, carrying out

their own regulatory ambitions and even blatantly, in many cases, clearly defying congressional directives.

Mr. Chairman, I believe this is totally unacceptable. And given this lack of accountability to this Congress, I believe this Congress should seriously examine the appropriateness of merging and reforming some of these agencies to ensure a greater level of accountability to the American public and to this Congress.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Sherman, for 2 minutes.

Mr. SHERMAN. I want to associate myself with the gentlelady from New York and her comments on the CARD Act.

Mr. Chairman, you will find the rest of my opening statement to be bipartisan and depressing at the same time.

Perhaps coincident with my arrival here in Congress, Congress has descended into a dysfunction so severe that even when we think we are affecting public policy and passing landmark legislation, the legislation does little more than add additional power to the Executive Branch agencies.

Our most obvious method of affecting public policy is to pass legislation through this committee, which far more often than not is simply ignored by the other body, or passing legislation that does little more than extend existing programs without change. But I think perhaps our most important method of affecting public policy is by lobbying and beseeching the Executive Branch agencies and urging them to use their enhanced authority with wisdom.

So I ask our witnesses to listen carefully to the advice you are about to hear, even if that advice is disguised in the form of a question. Listen carefully.

Perhaps our advice will contain a shred of wisdom. And in any case, our ability to influence your decisions is perhaps the largest remaining shred of the once preeminent Article 1 of the United States Constitution.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes gentleman from Georgia, Mr. Westmoreland, for 1 minute.

Mr. WESTMORELAND. Thank you, Mr. Chairman, and I appreciate you having this hearing.

First of all, let me just recognize all the panelists and thank you all for being here. I have read your bios and I have noticed that you are all attorneys, it seems like you are all bureaucrats, and none of you are bankers.

And in fact, from reading your bios, I would say that none of you have sat across the table from anybody wishing to borrow money. And I don't understand exactly how that works that you can, in your professional opinion, understand what makes a good loan and what makes a bad loan, what makes somebody more at risk than somebody else that is not at risk, what makes somebody's company better than somebody else's company?

And if you look at all the different things, the rules and regulations that you have put in place, you are not accountable to anybody.

And so I hope, Mr. Chairman, that this committee will look at trying to put these agencies under the Appropriations Committee and the appropriations process so we can at least have some say-so over exactly what rules and regs they make.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, for 1 minute.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I am incredibly concerned about the complete abuse of power by the regulators as they have been forcing legally operating, fully licensed financial companies out of business. Regulators have admitted this is happening, and even have a name for this coordinated effort. It is called "Operation Choke Point."

Regulators have admitted this is happening and do nothing about it. There is no denying it. I want to read an e-mail sent by a banker to a longstanding client in the nondepository lending space.

"Based on your performance, there is no way we shouldn't be a credit provider. Our only issue is and has always been the space in which you operate. It has never been the service that you provided or the way you operate. You have obviously done a brilliant job. It is the scrutiny that you, and now we, are under."

What we are seeing through Operation Choke Point and from these other regulators, as well as DOJ, should be a wakeup call to the entire Nation. I hope our witnesses can provide this committee with an explanation for the blanket targeting of an entire financial services sector.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, for 1 minute.

Mr. DUFFY. Thank you, Mr. Chairman.

Congress enacted the Federal Advisory Committee Act in 1972, over 40 years ago, and it was to ensure that Congress and the public understood what was going on in these meetings, what was being discussed, the cost to taxpayers, to provide basic transparency. Only the CIA and the Federal Reserve, for the purposes of the Open Market Committee, were exempt.

What I would like to hear is what the CFPB is doing in these meetings that is on par with the CIA, and why these meetings aren't open to Congress and to the public. On February 26th and 27th, I made a request to the CFPB to attend a Consumer Advisory Committee meeting. My staff was sent an e-mail that they—the CFPB—could not accommodate the Congressman's request, meaning I couldn't attend.

These meetings should be open. They should be transparent. The public and Congress should know what is going on and I would like to hear more testimony on this topic.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentlelady from Ohio, Mrs. Beatty, for 1 minute.

Mrs. BEATTY. Thank you, Mr. Chairman, Ranking Member Waters, and witnesses.

Today's hearing has a tricky title, but I think it is misplaced. Instead of having a one-panel hearing with only General Counsels

from the financial regulators here to testify, we could expand the testimony to include the various private sector participants whose business models have in the past put them in the wallets of the American public.

Market manipulation and predatory lending practices do not grow the size of the economic pie; they simply shift the pie from the victims to the takers. But today we are in a new day. No longer can credit card companies take advantage of consumers by charging fees for services that have no value or were never received.

Access to capital and credit from deep and liquid markets are the hallmarks of the American financial system, all of which were jeopardized during the financial crisis. Economic freedom, unlike these one-sided hearings, is about both the freedom we choose for what is best for our family's finances, and the freedom to do so without being subject to unlawful and unfair financial practices.

Thank you.

Chairman HENSARLING. We now welcome our witnesses.

Ms. Meredith Fuchs is the General Counsel of the CFPB. Ms. Fuchs joined the Bureau in 2011, where she has also served as Principal Deputy General Counsel and as Chief of Staff to Director Cordray.

She previously served as a staffer on the House Energy and Commerce Committee, and in a variety of legal positions in the private sector. She earned her law degree at NYU.

Mr. Richard Osterman is the Acting General Counsel of the FDIC. Before joining the FDIC, Mr. Osterman represented the Federal Home Loan Bank Board on regulatory matters, and supervised complex commercial litigation. He holds a law degree from the University of Baltimore School of Law.

Mr. Scott Alvarez is the General Counsel of the Board of Governors of the Federal Reserve System, a position he has held for almost a decade. His tenure at the Fed started in 1989, when he joined as Assistant General Counsel. He earned his law degree from Georgetown.

Mr. Michael McKenna is the General Counsel of the National Credit Union Administration, where he has served since 1989. In that role, Mr. McKenna serves as the primary legal advisor to the NCUA board, and supervises the provision of legal advice throughout the agency.

Prior to joining NCUA, Mr. McKenna served as Staff Judge Advocate for the U.S. Army at Fort Hood. He holds a law degree from American University.

Last but not least, Ms. Amy Friend is the Senior Deputy Comptroller and Chief Counsel of the OCC. Ms. Friend oversees all of the agency's legal activities, including legal advisory services to banks and examiners in enforcement and compliance activities, litigation, and legislative activities.

Prior to her service at OCC, Ms. Friend spent time in the private sector, and also served as a House staffer on this committee, so we welcome her back. She holds a law degree from Georgetown University.

Without objection, each of your written statements will be made a part of the record. I believe each of you is familiar with our green, yellow, and red lighting system at the witness table. I would

remind you, when it is your turn, to actually turn your microphone on and pull it very close to you so that all may hear your testimony.

I respectfully ask that each of you observe the 5-minute time allocation.

Ms. Fuchs, you are now recognized for 5 minutes.

STATEMENT OF MEREDITH FUCHS, GENERAL COUNSEL, CONSUMER FINANCIAL PROTECTION BUREAU (CFPB)

Ms. FUCHS. Thank you. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the invitation to testify today on the impact of regulation on financial markets and on consumers. My name is Meredith Fuchs and it is my privilege to serve as the General Counsel of the Consumer Financial Protection Bureau. As you know, the Bureau was created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in response to the recent financial crisis. The crisis resulted in part from failures of a Federal regulatory system, including the fragmented responsibility for consumer financial protection.

To address this problem, Congress created the Bureau. We are hard at work fulfilling the objectives that Congress set out for us, including ensuring that consumers have better information to make financial decisions, reducing unwarranted regulatory burdens, leveling the playing field for different kinds of entities offering the same kinds of products and services, and promoting transparent and efficient markets.

As the Dodd-Frank Act requires, the Bureau has issued regulations to strengthen the mortgage markets, to make Federal mortgage disclosures easier for consumers to understand and less burdensome for firms to make, and to establish standards for mortgage servicing. We also have issued rules to allow us to examine a range of larger nonbank participants in the consumer finance markets.

As we do this work, we employ a number of strategies to ensure that our rules are effective at protecting consumers and making consumer financial markets work. First, we consider the input of stakeholders. For example, our Office of Financial Institutions and Business Liaison connects the Bureau with bank and nonbank trade associations, financial institutions, and businesses to enhance collaboration and communication.

In addition, the Bureau is the only banking regulator, and one of only three Federal agencies that the Small Business Regulatory Enforcement Fairness Act requires to convene small-business review panels. Pursuant to the Act, before we propose a rule that would have significant economic impact on a substantial number of entities, we seek input directly from small entities on the potential cost and potentially less burdensome alternatives.

A second strategy that we use when considering regulation is, as required by the Dodd-Frank Act, to consciously consider potential benefits and costs and impacts of our rules to consumers and to financial service providers.

Where proposed regulation would have a significant economic impact on a substantial number of small entities, our analyses under the Regulatory Flexibility Act consider the compliance burdens of

the proposal, as compared to less burdensome alternatives. Moreover, where a proposed rule would impose disclosure, record-keeping, or information-collection requirements, the Bureau also considers the potential burden, and ways to minimize that burden, pursuant to the Paperwork Reduction Act.

Third, we act deliberately to reduce existing regulatory burdens. For example, as part of the Bureau's project to streamline the regulations that the agency inherited from seven different Federal agencies, we are working on a proposal that, if adopted, would reduce the requirements and the burden of providing annual privacy notices in certain circumstances.

Other examples are in my written testimony.

Currently, we are developing a comprehensive plan to assess the effectiveness of the significant rules that we have adopted under Federal consumer financial law within 5 years of their issuance, as Section 1022 of the Dodd-Frank Act requires.

Fourth, we are working to make it easier to comply with our regulations. To that end, we have implemented a comprehensive regulatory implementation program to help industry. For example, after we issued our new mortgage rules last January, we published plain-language compliance guides for small businesses and we published video presentations to give an overview of the rules, as well as a readiness guide and other implementation materials.

In close coordination with the other regulators, we developed and issued exam procedures as early as practicable. In addition, we provide oral guidance to industry participants who contact us. And where warranted, we have responded to stakeholder concerns by proposing and issuing amendments and clarifications to facilitate compliance with our rules and better protect consumers. There are examples in my written testimony.

Of course, despite our best efforts, not everyone complies with the law all the time, which brings me to our fifth strategy: holding parties who violate the law accountable through an effective supervision and enforcement program. Together, our supervision and enforcement programs have returned hundreds of millions of dollars to injured consumers, have halted violations of the law, and have led companies to strengthen their compliance systems.

Sixth and finally, the Bureau supports innovation in the marketplace through our Project Catalyst program and our Trial Disclosure program, under which companies can provide innovative disclosures or ways of delivering disclosures that are not currently permissible under existing regulations.

Thank you for the opportunity to discuss the Bureau's work with the committee.

[The prepared statement of Ms. Fuchs can be found on page 101 of the appendix.]

Chairman HENSARLING. Mr. Osterman, you are now recognized for 5 minutes.

STATEMENT OF RICHARD J. OSTERMAN, JR., ACTING GENERAL COUNSEL, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. OSTERMAN. Good morning, Chairman Hensarling, Ranking Member Waters, and members of the committee. I appreciate the

opportunity to testify today on recent regulatory activity of the Federal Deposit Insurance Corporation.

Despite continuing challenges for the banking industry, our regulatory activity is taking place in a gradually improving environment for banks of all sizes. Annual earnings in the industry have increased for the past 4 years; balance sheets have also improved.

As the industry has recovered, the Deposit Insurance Fund (DIF) has moved into a stronger financial position, from negative $20.9 billion at the end of 2009, to $47.2 billion at the end of 2013. And we remain on track to reach our statutorily required reserve ratio by 2020.

The number of problem banks has shrunk from a high of 888 in March of 2011 to 467 as of December 2013.

The number of bank failures also has been declining steadily. In 2013, there were only 24 bank failures, compared to the peak of 157 in 2010.

As the condition of the banking industry has improved, the total number of FDIC enforcement actions, both formal and informal, has decreased. Last year, enforcement actions decreased by 27 percent, and for the first time since 2008, the total number of enforcement actions terminated outpaced the number initiated.

With the industry recovering, the FDIC continues to work on regulatory improvements designed to address the causes of the financial crisis. Last year, the FDIC joined with the Federal Reserve and the OCC in issuing rules that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III international accord.

The agencies are currently finalizing an enhanced supplementary leverage ratio regulation that will significantly revise and strengthen the leverage capital requirements for the eight largest bank holding companies and their insured banks. The FDIC Board has scheduled a vote on a final rule later today. These higher capital requirements will help offset systemic risk and provide an additional private capital buffer before the DIF is put at risk.

In response to the significant liquidity problems experienced during the crisis, in October 2013 the banking agencies issued an NPR to implement a quantitative liquidity requirement consistent with the liquidity standards developed by the Basel Committee. The agencies are in the process of reviewing more than 100 comments received.

The FDIC and five other agencies also issued a second notice of proposed rulemaking to implement Section 941 of Dodd-Frank, which requires the sponsor of any asset-backed security to retain an economic interest equal to at least 5 percent of the aggregate credit risk of the collateral.

Before issuing the final rule, the agencies will give full consideration to all issues raised by stakeholders in their meetings with agency staff as well as 200 comment letters. Also, the FDIC and the Federal Reserve are currently reviewing the revised resolution plans required under Title I of Dodd-Frank Act for the largest, most systemically significant financial institutions under standards established under the statute.

When proposing a new rule, the FDIC considers the least costly options for achieving the public purpose of the rule. The FDIC pro-

vides the public with a notice of proposed rulemaking, an opportunity to submit comments, including comments on potential effects on financial institutions and consumers. The FDIC then carefully considers all comments submitted, weighs the impact of the proposed rule, and frequently makes changes in the final rule to address issues raised during the comment period.

The regulatory approach followed by the FDIC is intended to implement the statutes enacted by Congress. Rather than prohibiting financial products or services, the FDIC seeks to ensure that they are offered to consumers consistent with safe and sound banking practices.

As the primary Federal regulator for the majority of smaller institutions, the FDIC is keenly aware of the challenges facing community banks. In the rulemaking process, particular attention is focused on the impact that a regulation might have on small institutions and whether there are targeted alternatives that would minimize any burden. In both the final Volcker Rule and the Basel rulemaking, the banking agencies made several changes to the final regulations to address issues raised by community banks.

To address community bank concerns about the examination process, the FDIC has implemented a number of improvements to our procedures, particularly the pre-exam process, to help make examinations less intrusive and more efficient. We are providing technical assistance to help institutions with their compliance.

Mr. Chairman, this concludes my remarks. I would be glad to respond to your questions. Thank you.

[The prepared statement of Mr. Osterman can be found on page 120 of the appendix.]

Chairman HENSARLING. Mr. Alvarez, you are now recognized for 5 minutes.

STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. ALVAREZ. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee. I appreciate the opportunity to testify on recent rulemakings and other actions by the Federal Reserve.

The Federal Reserve is committed to strengthening the safety and soundness of the financial institutions it supervises so that these companies have the ability to meet their financial obligations and continue to make a broad variety of financial products and services available to households and businesses even in times of economic difficulty.

The Federal Reserve has made significant progress in implementing the Dodd-Frank Act reforms designed to improve the resiliency of financial firms and the system as a whole. At the same time, we recognize that regulatory compliance can impose a disproportionate burden on community banking organizations.

Community banking organizations tend to lend in neighborhoods where the institution's depositors live and work, making them important sources of credit in their local communities. The Federal Reserve has strived and will continue to strive to ensure that its regulations and supervisory framework are not unnecessarily burdensome for community banking organizations so they can continue

to perform their important functions in a safe and sound manner in local communities.

To achieve the goal of strengthening the quality and quantity of bank capital without imposing unnecessary burden, the Federal Reserve, in several recent rulemakings, made changes to address concerns raised by public commenters, designed, in particular, to reduce burden on community banking organizations. Many of the Basel III requirements will not apply to smaller banking organizations. The Federal Reserve and the other banking regulators also issued a community bank guide to the new capital rules to help noncomplex banking organizations understand the applicability of the new rules to their operations.

Similarly, last month the Federal Reserve published the results of its annual stress test, which demonstrated that the largest banking institutions in the United States are collectively much better positioned to continue to lend to households and businesses and to meet their financial commitments in a severe economic downturn than they were 5 years ago.

Overall, this exercise has resulted in the 18 largest banking firms increasing their tier one common equity by more than $500 billion since 2008. That means that the strongest form of loss-absorbing capital at the largest banking firms has more than doubled since the financial crisis.

Since enactment of the Dodd-Frank Act, the Federal Reserve has also completed a number of supervisory rulemakings, including adopting final rules that establish enhanced prudential standards for large banking organizations and rules that require large banking organizations annually to file plans to facilitate their resolution in bankruptcy.

Today, the Board will deliberate on whether to finalize a rulemaking regarding a proposed supplementary leverage ratio for large banking organizations. None of these rules apply to community banking organizations.

To become informed about the benefits and costs of a regulatory proposal, the Federal Reserve often collects information directly from those that we expect would be affected prior to designing the proposal. We also specifically seek comment on the costs and benefits of our proposed approach, invite comment on alternative approaches, and provide the public a minimum of 60 days to comment on all significant rulemaking proposals.

In adopting a final rule, we seek to adopt the approach that faithfully reflects the underlying statutory provisions while minimizing regulatory burden. We typically follow this same process of seeking and learning from public comment when issuing supervisory guidance even though we are not required to follow that process under the Administrative Procedures Act.

The Federal Reserve has made significant progress in implementing the Dodd-Frank Act and other measures designed to improve the resiliency of banking organizations and the financial system.

I thank you for the opportunity to be here, and I will do my best to answer your questions.

[The prepared statement of Mr. Alvarez can be found on page 69 of the appendix.]

Chairman HENSARLING. Mr. McKenna, you are now recognized for 5 minutes.

STATEMENT OF MICHAEL J. MCKENNA, GENERAL COUNSEL, NATIONAL CREDIT UNION ADMINISTRATION (NCUA)

Mr. MCKENNA. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee.

The National Credit Union Administration appreciates the invitation to testify about the agency's recent regulatory and supervisory activities. As a starting point, I want to emphasize that NCUA understands the need to strike a proper balance between implementing the safety and soundness considerations required by the Federal Credit Union Act and minimizing the bottom-line impact for the credit unions we regulate and insure.

NCUA has a tailored program designed to mitigate compliance costs and improve the examination process for all credit unions. Rather than adopting one-size-fits-all regulations, NCUA also targets agency's rules to risks and asset size. NCUA strives to ensure that the agency's rulemakings are reasonable and cost-effective.

The benefits associated with NCUA's rules primarily derive from addressing and mitigating safety and soundness risks in order to reduce the likelihood of credit union failures. By mitigating failures, NCUA protects the National Credit Union Share Insurance Fund, and in doing so, limits the financial burdens placed on the surviving credit unions that would bear the cost of failure.

In looking at compliance issues, many of the complaints raised by credit unions stem from laws like the Bank Secrecy Act or other requirements of other regulators. In such cases, NCUA has no ability to provide regulatory relief.

That said, NCUA does work to reduce regulatory burdens where possible for the rules it issues. However, as we learned from the recent financial crisis, sometimes the cost of regulatory inaction can be greater than the cost of action.

Since 1987, NCUA has followed a deliberate process to continually review the agency's rules on a rolling basis. This unique policy requires NCUA to review all of its rules every 3 years. It also ensures that NCUA's rules are up to date and reflect current realities.

Recognizing the changing financial services environment, NCUA Board Chairman Debbie Matz announced the agency's Regulatory Modernization Initiative in 2011. Under this initiative, NCUA is working to streamline and update the agency's regulatory framework.

Additionally, NCUA is developing targeted standards that address high-risk activities. Through this initiative, the NCUA board has approved four targeted rules to mitigate risk and six rules to cut regulatory burdens.

One rule that I want to highlight is NCUA's final rule on the definition of a small credit union. At the start of 2013, the NCUA board raised the threshold for a small credit union from $10 million to $50 million in assets and under. As a result of this change, two-thirds of federally-insured credit unions are exempted from regulatory requirements not suitable for small, noncomplex credit unions.

Additionally, 2,270 credit unions became eligible for assistance from NCUA's Office of Small Credit Union Initiatives, including access to free training sessions and consulting services.

NCUA is affirmatively reducing the regulatory burden of two-thirds of the institutions we regulate and is proactively providing them assistance to help them grow and prosper.

NCUA initiates rulemaking as a result of five factors. NCUA issues safety and soundness rules to address the lessons learned during the financial crisis or mitigate growing potential risks. NCUA also acts on rules when required by Congress, as was the case with the Dodd-Frank Act.

Additionally, the agency adopts rules in response to recommendations of the U.S. Government Accountability Office and NCUA's Inspector General, such as the proposed risk-based capital rule released earlier this year.

Often, NCUA issues rules to cut regulatory burdens or increase powers. Finally, NCUA modifies rules to address technical issues and provide greater clarity.

Since the start of 2013, the NCUA board has approved 17 final rules. Of these, one was required by the Dodd-Frank Act, five provided regulatory relief, four addressed safety and soundness matters, and the remaining seven rules were technical in nature.

In other words, 70 percent of NCUA's recent final rules have provided regulatory relief or greater clarity without imposing new compliance costs.

In closing, NCUA remains committed to continuing its rolling 3-year review of the agency's rules and finishing the Regulatory Modernization Initiative. We are also committed to working with Congress and other stakeholders to explore additional ways to address remaining concerns about NCUA's rules and the examination process.

I look forward to your questions.

[The prepared statement of Mr. McKenna can be found on page 107 of the appendix.]

Chairman HENSARLING. And Ms. Friend, you are now recognized for 5 minutes.

STATEMENT OF AMY S. FRIEND, SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

Ms. FRIEND. Thank you, Mr. Chairman.

Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for the opportunity to appear before you today to discuss our bank supervision, enforcement, and regulatory program.

The OCC supervises more than 1,700 national banks and Federal savings associations ranging in size from community banks with less than $100 million in assets, to large, complex financial institutions with more than a trillion dollars in assets.

Since the financial crisis, the banks we supervise have made great strides in repairing their balance sheets through stronger capital, improved liquidity, and the timely recognition and resolution of problem loans. We have a robust process for developing regulations and guidance that serve our safety and soundness mission

and also seeks to minimize the compliance burdens on supervised institutions, particularly community national banks and Federal savings associations.

We believe it is important to tailor all rules and guidance to the size of the institution and the complexity of its activities whenever possible. Community banks have different business models and more limited resources than larger banks. Therefore, we consider those differences as we write rules and guidance.

For example, in a number of recent rulemakings, such as our lending limits rule and the interagency Volcker Rulemaking, we streamlined compliance requirements for community institutions.

We now also specifically highlight the key aspects of each new rule or piece of guidance that applies to community banks and thrifts. This highlight, in the form of a text box in the bulletin that accompanies each new issuance, notifies community institutions whether they even need to read the issuance.

And in the case of more complex rulemakings, we have provided summary materials. For the new domestic capital rule, for example, we provided a concise two-page summary that gave community banks and thrifts the information they needed in a manageable form.

Since the financial crisis, along with strengthening the overall national banking and Federal thrift system, our priority has been to minimize burden to community banks so they can devote more of their time to serving their customers.

We take seriously the effect of our issuances on the public and private sectors of the economy. Towards this end, the OCC assesses the economic impact of our proposed and final rules.

When our analysis indicates that a rule will have an economically significant impact, we also prepare a more detailed economic assessment. That assessment includes a comparison to a baseline and consideration of one or more alternative approaches.

In addition to these analyses, the OCC and other Federal banking agencies are currently engaged in a wide-scale review to identify outdated or otherwise unnecessary regulations.

The Economic Growth and Regulatory Paperwork Reduction Act requires this review every 10 years. As Chair of the legal advisory group of the Federal Financial Institutions Examination Council (FFIEC), I have been tasked with coordinating this joint regulatory review.

The review provides the FFIEC, the agencies, and the public with an opportunity to identify and target regulatory changes to reduce burden on community institutions. We expect to publish the first Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) notice in the very near future, and we will specifically ask the public to consider this issue.

While we are mindful of the challenges facing banks today, we also recognize that businesses and consumers need access to credit through a variety of products. Although the OCC does not determine the specific types or terms of consumer products or services that banks offer, we expect the institutions we supervise to carefully evaluate the risks their products may pose both to the banks and to their customers.

From time to time, we have identified products that present substantial safety and soundness or consumer protection issues and we have issued guidance to address those concerns. On the other hand, we have seen a variety of properly structured products that provide consumers a safe and affordable means of meeting their financial objectives, and we support innovation by the industry to develop and make those products available.

Thank you again for the opportunity to appear, and I will be happy to answer your questions.

[The prepared statement of Ms. Friend can be found on page 81 of the appendix.]

Chairman HENSARLING. Thank you.

The Chair now recognizes himself for 5 minutes.

Ms. Fuchs, approximately a year ago the CFPB issued its enforcement bulletin entitled, "Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act." I assume you are well familiar with that bulletin?

In the intervening year, I am aware of at least seven different letters that have gone to Director Cordray that I somewhat assume ended up on your desk, signed by almost 100 Members of Congress, both Senators and Congressmen, both Republicans and Democrats, all seeking the same information, and that is CFPB's methodology in identifying different groups of consumers, the factors it is holding constant to ensure its findings of pricing differentials are attributable to the consumer's background, and the numerical threshold with which the Bureau determines so-called disparate impact.

In the intervening year, notwithstanding Director Cordray's public pronouncements that the CFPB would be transparent, we have yet to receive this information. Clearly, you are using some standard, since there was an enforcement action with respect to Allied Bank, so when does the CFPB intend on making this information public in explaining its methodology in regression analysis?

Ms. FUCHS. Mr. Chairman, thank you for your question.

The CFPB has been engaged in a regular dialogue with committee staff about this information, and I know that about 2 weeks ago committee staff did meet with CFPB employees, CFPB staff, and go through the work that we had done with respect to the Allied matter, including—

Chairman HENSARLING. But Ms. Fuchs, with respect to those who have to live under the standard, doesn't this standard not only have to be—doesn't this need to be made public?

Ms. FUCHS. The CFPB has talked about the methodology that it is using in connection with these auto investigations. We are also engaged—

Chairman HENSARLING. Have you specifically answered, though, the questions that have been posed by the Members of Congress?

Ms. FUCHS. To some extent, in these matters, the methodology will vary depending on the business model of each individual institution that we are engaged in either supervision or investigation of. And so there is not a one-size-fits-all process—

Chairman HENSARLING. Then, how is an indirect lender supposed to comply if all of this comes down to individual cases? Why isn't it to be observed that you are engaged in a de facto rulemaking without actually following the rulemaking process?

So, if there is something—if there is some standard by which these people are being held, why is there a rulemaking to amend Reg B?

Ms. FUCHS. The CFPB, when it is looking at indirect auto lending, is looking at it in much the same way as other regulators have looked at it. We do look at whether there are disparities that require any action, and then in the course of that—if we are in the middle of an investigation or an exam, we—

Chairman HENSARLING. So is there a methodology? Is there a numerical threshold? How is a bank supposed to comply?

Ms. FUCHS. As I mentioned, it varies somewhat from matter to matter because of the business model of each individual lender that we may be looking at. However, we have been engaged in a constant discussion with your staff about this, and we walked your staff through our methodology a week or so ago so they would have an opportunity to ask questions and review how we approached—

Chairman HENSARLING. I have to tell you, Ms. Fuchs, and I know that you are not personally responsible here, but for an agency that is supposed to be policing abusive practices, to essentially engage in de facto rulemaking without engaging in de jure rulemaking, strikes me as an abusive practice, and I would hope that the agency would go back and reflect upon their actions, and answer the questions of Members of Congress on both sides of the Capitol, on both sides of the aisle.

Now, in the time I have remaining, Ms. Fuchs, I guess you are also quite aware of the purpose of our hearing last week dealing with an American Banker article that revealed disparities in the ratings employees have received in the Bureau's annual employee review process. Can I assume that you are familiar with the American Banker article?

Ms. FUCHS. Yes, sir.

Chairman HENSARLING. Does the CFPB take issue with the data that was presented in the American Banker article? Do you refute the statistics?

Ms. FUCHS. Mr. Chairman, I see the time has expired. May I respond?

Chairman HENSARLING. You may respond.

Ms. FUCHS. The CFPB takes the data that was reported in the American Banker article very seriously. The CFPB itself has been evaluating its performance management system, and thus collected the data that was provided to the American Banker.

When we saw that there were concerns, we addressed this proactively with the National Treasury Employees Union, which is the labor union that represents the single bargaining unit at the CFPB, because we are in a process of negotiating our first collective bargaining agreement. And as you can imagine, performance management is an issue of great concern to that collective bargaining agreement.

So we are affirmatively trying to address the disparities that were talked about in the—

Chairman HENSARLING. Ms. Fuchs, I am now well over my time. I just would say you certainly create the impression that you are trying to impose a standard upon others that you are incapable of living under yourself.

The ranking member is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Although the Dodd-Frank Act included an extensive number of provisions designed to reduce regulatory burdens for community banks and credit unions, I have continued to hear from a number of institutions over the past year that additional relief is needed.

In fact, over the past year, Members on our side of the aisle have worked hard to solicit the concerns and understand the unique challenges faced by smaller financial institutions in order to see whether there was a way for the Congress and the regulators to provide some relief.

Despite our best efforts to come up with legislation that would create relief in a responsible manner, these efforts would appear to have fallen on deaf ears here in the Financial Services Committee.

Given this, I would like to know, what about the specific concerns you are hearing from the small institutions you regulate? How do you incorporate the unique concerns of community banks and financial institutions into your rulemaking? What types of resources are available to small institutions to ensure they are informed of their legal obligations as part of any rules that your agencies promulgate?

Since you have already started, Ms. Fuchs, let's start with Mr. Osterman.

Mr. OSTERMAN. Thank you for your question.

At the FDIC, we look at the impact of potential regulations and rules on community banks. First off, in terms of the examination process, while with the larger institutions there is continuous examination, with the smaller institutions, the time between examinations can run from 12 months to 18 months.

And we actually did a community banking study last year, and in that we determined that the community banking model continues to be a very viable and important one in terms of making loans to communities.

What we have done, as we mentioned in our opening remarks on the Basel rulemaking, is we actually exempted community banks from certain provisions. That also happened in Volcker.

And in connection with financial institution letters, we actually put on the top of those whether they apply to institutions of a billion dollars or less so that community banks can easily find that information and avoid dealing with tons of paper. We also have created Webinars for community bankers to provide them technical assistance.

So, there are many things that we have done and we are open to continuing to try to support the community banking model.

Ms. WATERS. Mr. Alvarez?

Mr. ALVAREZ. Yes, Congresswoman Waters. We do many of the same things that the FDIC and the OCC do in outreach to the community banks to make sure that we understand their concerns and we take them into account in our rulemaking processes. We also prepare small bank compliance guides with our major rulemakings to provide simple guidance about how to comply with the rules.

We also have formed 12 community depository institution councils, one in each of our reserve bank districts. We consult with these councils about the rules that we put forward and the regu-

latory burden associated with our supervision. One representative from each of those 12 councils sits on a national council that meets with our Board of Governors on a regular basis to, again, raise issues about supervision of small institutions.

So we try our best to, wherever possible under the statute, give room to small institutions.

Ms. WATERS. Mr. McKenna?

Mr. MCKENNA. Thank you, Congresswoman Waters.

Our small credit union office assists credit unions with assets less than $50 million, and we have a rulemaking program that we always look for credit unions under $50 million to see if they can be exempt for our rulemaking or have less burdensome rules. In fact, when we did a final rule on emergency liquidity and interest rate risk policy, on those two rules, the standards and requirements for small credit unions were less.

We have a proposed risk-based capital rule, and credit unions under $50 million would not be subject to that. So we are always looking to target our rules and to try to exempt small credit unions when we can.

Ms. WATERS. Ms. Friend?

Ms. FRIEND. Congresswoman, in addition to the capital rules and the Volcker Rules that my colleagues talked about, the OCC recently issued a lending limits rule under the Dodd-Frank Act that sought to take into account derivatives exposures, and they are in response to comments and meetings that we had with community banks. We gave them an easy lookup table, the methodology that was much more tailored to them, as well as exempting a number of transactions that they are usually involved in.

So we also go the extra mile to try to accommodate the concerns we hear from community banks through our regulations and our issuances.

Ms. WATERS. Thank you all so very much. You are doing a great job.

Chairman HENSARLING. The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, chairman of our Housing and Insurance Subcommittee, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, and thank you for having this important hearing.

Ms. Fuchs, I am going to go back to some questioning that the chairman—and I want to go from a little bit different angle. Obviously, we are all very concerned about the lack of transparency, the lack of responsiveness to the agency on this issue of the car dealers that are brought up about this compliance issue, but here is what we need to think about that: I don't think you want to be responsible for keeping that single mom with two kids who is working two jobs from being able to get a car loan so that she can get to and from work and to take her kids to school. You don't want to be responsible for that, do you?

Ms. FUCHS. No, sir.

Mr. NEUGEBAUER. But you see, that is what is going on right now is that the uncertainty that your agency is creating—I have had an opportunity to sit down with a number of car dealers, and basically the way that works is that people come in their dealerships needing transportation, but what is going to happen right

now, with the fact that people don't really know what the clear lines are, is that people who need a car, need transportation, may not go away with it because maybe she is just—that single mom is just recently divorced and she has a little bit of a blemish on her credit report.

And so they need to put her—may possibly recommend that she go with a different financing option that lots of dealers, quite honestly, tell me that they are very concerned about steering people to where they can complete the transaction.

And so what is going to happen is that only the people with really good credit and who are within the lines, whether it be a car or a mortgage or any other type of financial transaction, we are beginning to take away the choices that consumers have. And if that is the kind of consumer protection that you are providing to consumers, I think they don't want any more of it.

So I just—I think that you all need to come clean on how you are determining this so everybody knows what the lines look like, because the fact that the lines aren't clear right now is, I think, damaging and creating an inability for some people to access some of our capital markets and get much-needed credit.

I want to go to Mr. Alvarez.

The Financial Stability Board (FSB) recently issued mandates to the International Association of Insurance Supervisors (IAIS) to develop global capital standards for insurers, something not supported by our own State regulators. What objective evidence was relied on to support this mandate, and what cost-benefit analysis was done by you or the FSB or any of the other people supporting this mandate?

Mr. ALVAREZ. Congressman, as you pointed out, this is something being done by the FSB, which is not the Federal Reserve.

Mr. NEUGEBAUER. I understand.

Mr. ALVAREZ. And we were only recently granted a seat on the IAIS, which is the international insurance review body. So we have not begun—we are now beginning to participate in it; we have not yet been part of the meetings.

So we will be learning about this process and participate in this process. We look forward to working—we have a very good working relationship with the State insurance commissioners and we will continue that relationship and work well with them on the international front.

Mr. NEUGEBAUER. Is this something that the Fed supports, though? Do you support developing international standards to impose on domestic insurance companies?

Mr. ALVAREZ. I think the effort is designed to make sure that global systemically important insurance companies, of which there will no more than a handful, are held to standards that ensure that they don't create systemic risk and that there is a competitive sort of level playing field internationally for those largest of insurance companies.

That is something that we think is worth exploring. We have no predetermined idea on how to do that, so—

Mr. NEUGEBAUER. So what would be a way that the Fed would work with the State regulators and the domestic insurance companies to get their input on this issue? Because I think one of the

things I hear from a number of them is that they don't feel like they really, in many cases, have a seat at the table and some of these discussions aren't very transparent.

Mr. ALVAREZ. Understood. And so we meet quite regularly with— the Federal Reserve has just gotten responsibility under the Dodd-Frank Act for supervising designated systemically important institutions, a couple of which include insurance companies and savings and loan holding companies, which include a number of insurance companies.

So we have begun discussions with insurance companies directly to understand their business model, to understand the capital regime that they are under, the supervisory regime they are under. We also meet with the NAIC, and in particular certain lead insurance regulators, to understand the framework. We want to be educated there.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New York, Mr. Meeks, the ranking member of our Financial Institutions Subcommittee.

Mr. MEEKS. Thank you, Mr. Chairman.

I didn't get a chance to make an opening statement, but I want to thank all of you for what you do. I think it is tremendously important.

After the crisis, we knew we had to do better, and that is what Dodd-Frank was all about. And I appreciate the work that you are doing. We should learn from those crises and try to make sure we do better.

I have heard, and I am sure you have heard a lot about the detrimental impacts of one-size-fits-all regulations or banking supervision. And that has been particularly devastating for community banks and credit unions. And all of your structures, or all of you in your leadership structures, have an office or a council or a committee that is exclusively dedicated to community banking issues for small and mid-sized financial institutions.

However, the U.S. Treasury, which plays a major role in setting economic policy and financial and banking policies, which often have to regulate, does not have such an office. And they have all sizes—this one-size-fits-all has been devastating, as you know, because of the number of community and financial institutions that keep failing due to regulatory burdens.

I am working on a piece of legislation that would direct the U.S. Treasury to reassign one of its Assistant Secretaries to community financial institutions so that we have properly calibrated policies that are appropriate to their business model and environment.

So my question is, do you agree with me that we need to make sure that we have appropriate banking policies and supervision that are properly calibrated to the needs and business models of community financial institutions?

I guess I will first address that to Mr. Alvarez.

Mr. ALVAREZ. We do believe that regulation should fit the activities and the complexity and the size of the organization. In fact, as I mentioned, we have set up several councils to try to make sure we understand and have input from community banks in particular about the rules that we design. And we seek public comment al-

ways on alternative approaches that reduce burdens, especially for community—

Mr. MEEKS. And Treasury should follow that rule, don't you think?

Mr. ALVAREZ. Treasury doesn't have a direct supervisory role, as we do, so I don't know why they—

Mr. MEEKS. I am just saying a role of having—making sure that we don't have one-size-fits-all, that they should have someone who can focus on the rules and regulations on small and community banks and credit unions so that they are not mixed in with the super big. That would make sense. Doesn't that make sense to you?

Mr. ALVAREZ. It makes sense to me.

Mr. MEEKS. Yes.

You too, Ms. Friend?

Ms. FRIEND. Congressman, I definitely agree that one-size-fits-all is not the way to go. And we have taken action to make sure that doesn't happen wherever we can.

Mr. MEEKS. Thank you.

And I would assume—I don't think anybody really disagrees with me on that point, right? Okay. Silence. Okay.

Let me ask Mr. Osterman this question—and this might not be the case in other States, but I know it affects my State of New York. Number one, I, like you, want to make sure that we get rid of any—and eliminate any illegal payday lenders that are in New York and elsewhere. I want to make sure that those are illegal. We want to get rid of all of those folks, those that are hurting people in that regard.

But I also want to make sure that we don't throw the baby out with the bath water in that if you have someone that is legal and doing good work, that we eliminate them. That is starting to take place in New York with some of the check cashers.

For example, I was recently told that Capital One Bank notified all of its check-cashing companies that it was terminating their bank accounts and that Cap One happens to be banking more than half of all the New York check-cashing companies. Now they are scrambling, they are trying to find some other banks, but if they don't, they will go out of business. And that is particularly concerning to me because I know, for example, when I lived in public housing, my parents paid their rent through the check-cashing places.

So my question to you is, how can you assure me that your efforts to make sure that we are cutting out the illegal businesses is not causing legal businesses to be denied banking services? And are these businesses—will they be able to find other accounts in the future, provided they can assure that they are legal and operating within compliance of the appropriate rules and regulations?

Mr. OSTERMAN. Thank you for your question. The FDIC's efforts are really focused on making sure that institutions are aware of the risks associated with working with third-party payment processors and high-risk merchants and making sure that they take appropriate action. We have actually put out a policy statement that indicates that as long as financial institutions properly manage these relationships and risks, they are neither prohibited nor discouraged from providing payment processing services.

And in fact, I noted that in the American Banker this morning, there was an article regarding the fact that the payments industry is looking at ways to try to address the concerns that have been raised, so they can work with the banks.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets and GSEs Subcommittee, for 5 minutes.

Mr. GARRETT. Thanks, Mr. Chairman.

You know, 2 months ago this committee held a hearing with the principals of various agencies before us dealing with the CLO market and the consequences of the Volcker Rule as it is being implemented. Now, 2 months later and the night before our hearing today, we have seen come out somewhat of a half-baked proposal to try to solve this problem by the regulators.

The issues dealing with the CLO are extremely important, and it is becoming clear to me that besides this particular issue, but the way that this issue and other issues are being handled, it has become clear to me that the banking regulators that are before us basically have a contempt for the American public and this Congress in the manner that they handle it.

Let me begin with Ms. Friend. As a former top Senate Banking staffer, I would assume that you have a firm foundation on the notion that the financial regulatory community is acting under the auspices and the authority given to it by Congress. I know that you helped write much of Dodd-Frank.

And let me then refer you to some of the statutory language and others in the Volcker Rule, under rules of constructions, that said, "Nothing in this section shall be construed to limit or restrict the ability of a banking entity or a nonbank financial company by the board to sell or securitize loans in a manner otherwise permitted by law."

Also, a study was done in the FSOC study on the Volcker Rule. It said, "The creation and securitization of loans is a basic and critical mechanism of capital formation. Congress determined that none of the restrictions of the Volcker Rule or its backstops will apply to the sale or securitization of loans."

It seems amazingly clear to me what the intent of Congress was, but apparently, it was not amazingly clear to the regulators.

I guess my question is, if the banking regulator is not up to it as far as following the clear rule of the law that Congress passes, and if they are not up to following their own studies and interpretation of that law, should the Congress rethink granting all the power to the regulators, or should we do something else to hold the regulators accountable when they cannot follow the rule of law?

Ms. FRIEND. The CLOs that are at issue are loans, but they are also debt and equity, and so the way we issue the regulation, which we believe is consistent with the intent of Congress, it would catch these CLOs and—

Mr. GARRETT. Obviously, you are not following the intent, when the intent of the statute I just read to you could not have been clearer. You were there when this was being created. The intent of the sponsors was clear. I am at a loss as to why the regulators are blind to this.

Turning now to the Fed, Mr. Alvarez, each year the Fed does what is called an operations review report—basically a yearly performance review of the Fed's different teams of supervisory and examination staff. And I know you are familiar with it. I have here a copy of the 2009 report of the New York Fed.

Now, there is much criticism of the Fed as far as its banking regulatory role, not to mention its monetary policy. But to help Congress out here, I think it would be helpful for members of this committee to see not just what has been provided, but unredacted copies of the operation review report from 2000 and 2003 of the time leading up to the financial crisis.

Could you please provide members of this committee with an opportunity to review these reports?

Mr. ALVAREZ. The operations review is an examination that we do of the reserve banks to make sure that they are implementing the policies and following the directions of the Board of Governors—

Mr. GARRETT. Right. And the question is, can you provide us with an unredacted copy of that so we can have the information to know what you were doing up to the crisis so we can see whether it is justified as far as the criticism of the way that regulators handle the crisis leading up to it? That is a yes-or-no question.

Mr. ALVAREZ. I think it would be something that we would be willing to discuss with you.

Mr. GARRETT. Thank you.

Mr. Alvarez, in my last minute, the G-20 created the FSB several years ago. It appears that the Fed is working closely with the FSB.

However, the inner workings of the FSB are to the public and Congress basically a black box. I am wondering whether or not you can assure us that more information will be given to us as to the operations of them, and also tell us, inasmuch as the FSB has designated, secondly, MetLife as a global systemically important institution, does that mean FSOC is going to be forced to designate MetLife as an SIFI or any other entities that FSB designates as a globally systemic institution?

And my time is out. I would look forward to the Chair letting them answer those questions?

Chairman HENSARLING. The witness can have a brief moment to answer.

Mr. ALVAREZ. The designation in the United States is up to the FSOC, not the FSB. The FSB designation doesn't have the force of law in the United States.

It would be a source of criticism of the operations of the regulations in the United States and the U.S. system if there wasn't some kind of implementation of FSB rules. But the decision is a U.S. decision.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

And this first question is directed to Mr. Osterman.

I support what you are doing to cut off illegal payday lenders who operate on the Internet. However, regulator pressure and Operation Choke Point has also caused many banks to stop banking

legal and licensed Missouri companies that provide essential financial services to many of my constituents. The ends do not justify the means, especially when consumers are hurt the most.

My constituents need basic services. They are folks who have families. They need to cash their checks and pay their bills.

They need to be able to get a loan so that they can get some cash when they need it. And they need to be able to do this every day where they live. These are folks who cannot get loans from banks either because banks are not in the community or simply can't or won't cash their checks or make small-dollar advances.

Last week I sat down with a young constituent and executive, an Air Force vet, and a father who told me about needing an advance to pay his son's college tuition on time. His son is on a partial basketball scholarship but the college wanted his money.

His bank wouldn't give him a loan. He was able to get a loan because a small, nonbank lender was there to give it to him. I asked him if it was expensive, and he said it was and that he understood both the annual percentage rate, the actual dollar cost, and made the decision to get the money, pay the college on time, and pay off the advance early.

He said that he counts on the relationship he worked to build with the nonbank lender and has used it for several cash flow emergencies.

Now, I am hearing that legitimate small lenders of the type that helped this young man are having their bank accounts closed, as Mr. Meeks mentioned earlier. And I am very concerned about the situation because it is going to hurt my constituents who need the services.

Can you assure me that this was not what you intended when you went after illegal businesses?

Mr. OSTERMAN. Congressman, I can assure you that FDIC was not—what we were trying to do, actually, with the Operation Choke Point—which actually was not our program; it was a DOJ program—was to help them to stop illegal activity. We have put out a financial institution letter making it clear to our examiners as well as to the industry that our supervisory efforts are focused on making sure institutions are acting in a safe and sound manner and that as long as the activities of these payment processors are done in a way that avoids risk, the institution should go ahead and work with these entities. And in fact, we have met with our regional offices and field office examiners and given that message to them, as well.

So we issued an actual financial institutions letter back in September of last year to address the issue.

Mr. CLAY. So have those closures of the bank accounts—has that ceased?

Mr. OSTERMAN. I am hearing that there—that may be still going on to some degree. And I think to the extent that is happening, we would like to hear about it, because that is not the message that we are trying to send.

Mr. CLAY. All right. I will certainly share that with you.

Let me ask Ms. Fuchs, how did the CFPB get off—as the chairman mentioned—to such a poor start in regard to disparities in

evaluating employees, as well as giving out bonuses? What happened there?

Ms. FUCHS. Mr. Clay, I understand your question to be about our performance management system and the American Banker article. The CFPB is right now conducting further evaluation of that data.

We are also going to be engaging an outside resource to help us with that evaluation. The kind of institution we are trying to build is one which is fair and transparent for all employees.

The performance management system is also something that we are currently negotiating with the National Treasury Employees Union, so we will have good representation of views during that discussion. And that is the work that we are trying to do to address what that data showed.

Mr. CLAY. And you all have been up and running for about, what, 3 years?

Ms. FUCHS. We have been up and running for 3 years. During a large part of that time we were doing the work that Congress asked us to do by writing rules to fix mortgage markets.

Mr. CLAY. Thank you for your response.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. McHenry, chairman of our Oversight and Investigations Subcommittee, for 5 minutes.

Mr. MCHENRY. I certainly appreciate my colleague from Missouri asking that question of the CFPB, because you did contract with an outside investigator to determine that there was retaliation against an employee, but 6 months later, the Bureau has done nothing. So simply contracting with outside groups does not address the deep problems the CFPB has.

But to my colleague's other point, which is Operation Choke Point, I do want to bring this up with Mr. Osterman. You want to stamp out illegal businesses, but in order to do that you need to give legal businesses proper guidelines so they can be banked.

The Electronic Transactions Association has put forward a significant report that they worked on for the last 8 or 9 months. Are you familiar with this report?

Mr. OSTERMAN. I am not.

Mr. MCHENRY. You are not? Okay. They have indicated that they have been in contact with the FDIC to give their merchants and independent sales organization the underwriting and risk tools necessary to comply. Will you take a look at that?

Mr. OSTERMAN. Absolutely.

Mr. MCHENRY. Okay. Then, the additional question would be this: Is the FDIC coordinating with the CFPB to give guidelines to banks so that they can bank these institutions that are providing a legal service for a legal entity?

Mr. OSTERMAN. Of course, the CFPB Director is on our Board, so to that extent—

Mr. MCHENRY. I am familiar with the construct of it, but are you coordinating in terms of rule-writing?

Mr. OSTERMAN. We are not doing the rule-writing on the—

Mr. MCHENRY. That is part of the problem. The industry doesn't have guidelines by which they can follow what they believe the FDIC's intent is.

Mr. OSTERMAN. In that regard, as I mentioned, we do have a financial institutions letter that does lay out our guidelines in connection with these types of programs. And basically, what we are saying is these types of programs can involve high-risk activities that could create litigation risk and reputation risk for financial institutions. So, they need to do due diligence to ensure that the folks whom they are banking are acting in a safe and sound manner.

Mr. MCHENRY. Sure. Okay.

Mr. OSTERMAN. And so—

Mr. MCHENRY. My time is brief, and I have another question for Ms. Friend.

Mr. OSTERMAN. Yes.

Mr. MCHENRY. I know others will have questions about this.

I was notified about three OCC examinations, at three different financial institutions. I just want to tell you this story and get your response.

At bank one—not a bank—Bank A, if you will—the problem began when examiners expressed concerns about the bank's military accounts using an overdraft service. The examiner pulled data and was concerned about the frequent usage of overdraft with this account.

When the examiner was informed that this account was 5 to 10 years old, and that the user had regularly utilized overdraft, the examiner said it was proper that if the person kept using this overdraft protection and it became a behavior, they should close the account.

Now, when indicated that the person requested overdraft protection and utilized it they said, "Well, it could pose a reputational risk."

At Bank B, an examiner required that the bank remove overdraft service if the account holder withdraws or uses overdraft protection more than 25 times a year. And after implementing what the bank was told to do by the examiner, the customer came back and demanded that overdraft protection be put back on.

At Bank Three or C, the definition of frequent user was trying to—was—tried to be divined from the examiner and was told a very different story than the first two institutions were told.

Is there a justification for having different rules for different institutions about overdraft protection?

Ms. FRIEND. Congressman, there is a rule on overdrafts, and our examiners should be following the specific rule. We don't have separate guidance to examiners on overdraft protection beyond the regulation.

Mr. MCHENRY. Are examiners supposed to tell folks to close accounts if they are utilizing overdraft protection within the guidelines you have given?

Ms. FRIEND. I don't think that we have specific separate guidance that is independent of the regulations, so they would be expected to act in accordance with the regulations.

Mr. MCHENRY. Okay. And would you believe that this inconsistency of regulation would lead to more underbanked, or those who are unbanked?

Ms. FRIEND. I think we would be concerned if there is an inconsistent interpretation, and so it is difficult to respond with respect

to each individual institution without having all of the information available. But again, we look for consistency in examination based on the rules.

Mr. MCHENRY. And this is highly inconsistent.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Let me ask my first question to you, Ms. Fuchs, with the CFPB. I want to follow up on the Chairman Hensarling's point.

What we have here, the situation that the CFPB has placed our auto dealers in is no man's land. We sort of got them in a situation where they are guilty if they do, guilty if they don't, and when you put these two factors together, in your letter of—or your rule-making and guidance of last March 13th, you arbitrarily issued a statement of discrimination within the auto lending's indirect lending program.

Now, when you make a charge of discrimination against African-Americans or minorities anywhere, that is very explosive. Race is very explosive. You are dealing with a situation yourself with charges of discrimination within the ranks and the employment and promotion of the CFPB.

I only raise that point to let you know that in your response to Mr. Clay you were very thoughtful, you went back, we are doing this, we are trying to get at the bottom of this. But you are not treating the auto industry with that same kind of sensitivity.

And what you have done is—the CFPB has, I think, an unintended consequence here by making a blanket statement and then not giving guidance the background, the data, the methodology, all the things that you are looking at yourself in dealing with your own discrimination charges.

So, it is important to me and to other members of this committee that we get this threat away from these auto dealers. On the one hand, they put forward a solution of offering a standard fee and then working with the consumer in a way in which they could have a discounting of the interest rate. You take that away from the dealers and some of these dealers might have to close up shop.

Many of them, particularly in a district like mine—I represent the metro area; I represent six counties around Atlanta, where the auto dealers are, and smaller community towns where they anchor that community. They go out of business because of this.

So I want to urge you and the CFPB to resolve this issue and get the auto dealers out of limbo and remove the threat to their ability to discount those interest rates for their customers. If there is discrimination, I don't know where it is. All I am saying is treat them the way you are treating yourself in this. And if it is there, if there is a fire of discrimination there, we will put that fire out. But don't throw the whole blanket on them and assume.

There are many minority-owned dealerships. And if you throw that blanket on them, you are saying that African-American dealers are discriminating against African-American people? No. That is not the case here, but that is the situation you are in.

But I wanted to say that. Will you do that? Would you get this threat away from the auto dealers?

Ms. FUCHS. Thank you so much for your comments, sir.

I should say the question was asked earlier of whether we want a single parent to have access to a car, and we do. We want those people to have access to fair and transparent lending, as well. The CFPB does not have jurisdiction over auto dealers. We have authority with respect to indirect auto lenders.

Mr. SCOTT. But you have made a claim there. Where is the proof? We have asked for that. Show us where that discrimination is?

Ms. FUCHS. Thank you, sir. We are engaged in a constant dialogue with the industry about these issues. We held a forum at which various methods of compensating dealers were discussed. We have also had briefing calls with many, many stakeholders and spoken at auto dealers conferences.

Mr. SCOTT. Okay. Okay, thank you. I didn't mean to go on for so long, but I have to ask a question of the FDIC, please, thank you. But let's help those dealers.

On the operation—I have put it here someplace; what did I say. I got so carried away with that comment.

Oh, the Operation Choke Point—FDIC—can you tell us what is going on there?

Chairman HENSARLING. Regrettably—

Mr. SCOTT. Thank you. I'm sorry.

Chairman HENSARLING. My sense is that some other Member may be asking those questions before the day is over.

The Chair now recognizes another gentleman from Georgia, Mr. Westmoreland, for 5 minutes.

Mr. WESTMORELAND. Thank you Mr. Chairman,

Ms. Fuchs, would you describe in one sentence maybe, what is the role of the CFPB?

Ms. FUCHS. Congress set the purpose of the CFPB in the Dodd-Frank Act, and—

Mr. WESTMORELAND. Not what Congress said. What do you say the role of it is?

Ms. FUCHS. The role of the CFPB is to help make the markets for consumer finance more transparent and to enable consumers to have access to fair and transparent products and services.

Mr. WESTMORELAND. Okay. And going back to what the gentleman from Missouri asked about, the gentleman who got a loan for his son's tuition, if somebody, let's say BNC credit, needed $500 or $800 and called the CFPB and said, "Hey, you know, I have BNC credit," where would you recommend that they go to borrow that money?

Ms. FUCHS. It is hard in the abstract to recommend where a person should go to get short-term, small-dollar credit. It would depend on the circumstance of the person and what was available to them.

Mr. WESTMORELAND. But what would you recommend? A big bank? Bank of America? What would you recommend to him? What would be your choices?

Ms. FUCHS. There are many choices out there right now for consumers. There are opportunities to go to banks for credit, and there are opportunities to go to nonbank lenders for credit. It really will depend on the circumstances of the consumer, such as if they have

savings or if they don't have savings—they may have different options available to them.

Mr. WESTMORELAND. I don't think there are as many out there as you think there are. And Operation Choke Point, as my colleague from Georgia has pointed out, is trying to put as many of these people out of business as you can.

I want to read a statement from Bill Isaac, who is the former Chairman of the FDIC. He recently stated, "the same slippery slope that the DOJ uses today to choke off payday lenders from banking services could tomorrow be used on convenience stores selling large, sugary sodas, restaurants offering foods with high trans fat content, or family planning clinics performing abortions.

"Ironically, at the same time the government is making life miserable for businesses seeking to meet consumers' needs for emergency funds, it is encouraging banks to offer services to marijuana dealers."

Now, how do you all right that?

Mr. Osterman?

Mr. OSTERMAN. In terms of—I am not quite sure I understand your question, sir.

Mr. WESTMORELAND. The question is, when you are trying to keep people who have a lending service that they are doing to people who might not be able to walk in to a normal, traditional bank and do business, and you are trying to put out of business some of those people who do provide that service while at the same time trying to make it possible where banks can do business with people who sell federally illegal drugs?

Mr. OSTERMAN. We are not trying to put legitimate businesses out of business.

Mr. WESTMORELAND. You are not?

Mr. OSTERMAN. No sir, we are not.

Mr. WESTMORELAND. Okay. Have you ever put anybody out of business or kept anybody that was State-regulated, or federally-regulated from doing business with a bank?

Mr. OSTERMAN. In terms of what we are looking at is the safety and soundness of our banks, and as we have said—

Mr. WESTMORELAND. I know that. I know you are. But have you ever told somebody who had a legal business, as either regulated by the State or the Federal Government, that they could not—that a bank could not do business with them?

Mr. OSTERMAN. Not that I am aware of.

Mr. WESTMORELAND. Okay. So, Operation Choke Point has no reality to it?

Mr. OSTERMAN. Operation Choke Point, as I have said before, sir, is a Department of Justice program that was going after illegal activity, and we were asked to provide more information and that is what we did to address illegal activity. We did put out a financial institution letter to make it clear—

Mr. WESTMORELAND. How do you describe illegal activity when somebody is regulated by some State board—

Mr. OSTERMAN. Well—

Mr. WESTMORELAND. —that permits them to do business? How is that an illegal activity?

Mr. OSTERMAN. For example, for payday lenders—in several States, payday lending is illegal. And so, when banks are dealing with these lenders and they are in different States, the banks need to be assured that those lenders are, in fact, acting in a legal way. Because if they are not, it actually opens up the institution to risk, in terms of being sued by State attorneys general and others because they are not complying with the law.

Mr. WESTMORELAND. Just typical, picking winners and losers.

Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green, the ranking member of our Oversight and Investigations Subcommittee.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Chairman, understanding that the rules do not allow us to yield a specific amount of time, I would like to at this time yield up to 1 minute, such time as he may consume up to 1 minute, to my friend from Georgia, Mr. Scott.

Mr. SCOTT. Mr. Green, you are very kind. You are a good man. God bless you. Thank you.

Because this is important to me, on the Operation Choke Point, the gentleman from the FDIC, you are basically working with the Justice Department on this, as I believe I understand, doing a fairly good job in terms of getting the scam artists and those.

But without perfectly clear guidance and direction, it could go a little too far. For example, I am concerned about what you refer to in your guidance as a firm with a reputational risk.

What does that mean, reputational risk? Because my fear is that it could have an unintended consequence.

Mr. OSTERMAN. Typically, in terms of high-risk activities, these are things that the institutions themselves, the banks themselves, have to make a business determination on whether they are willing to enter into an arrangement with that entity.

But for example, as I said before, if payday lending was illegal in a particular State, to actually provide that service, that creates reputational risk to the institution because it is then being seen as engaged in illegal activity.

And so what we have said in our guidance is that banks should do due diligence to ensure that they are identifying potential risks. And as long as they properly manage the relationships and risks, then they are not going to be prohibited—we are not prohibiting them from entering—

Mr. SCOTT. Are there other industries? Payday lending makes a good point in other States, but are there other industries where you categorize as reputational risk?

Thank you, Mr. Chairman. Thank you, Mr. Green.

Mr. GREEN. Thank you. I thank the gentleman for yielding back.

Mr. Chairman, I would like to, if I may, just extend a welcome to Mr. Horsford to the committee. He has acquitted himself well since he has been in Congress, and I am confident that he will do a very good job, an exceedingly good job on this committee.

I am one of the many persons interested in helping small banks, and we have endeavored, in doing this, to find out what a community bank is. We have allowed this term to become pervasive.

While I see it as a good term, it is rather nebulous. And I have not, to this day, been able to get a good definition of a community bank. So let me shy away from the term "community bank," and let's talk for just a bit about small banks.

And my first question will go to the gentleman from the FDIC. I would like to know, is it true that most banks in this country are small banks and that as many as 90 percent of all banks are small if I use $1 billion or less as my benchmark?

Mr. OSTERMAN. Yes, that is correct.

Mr. GREEN. So we have 90 percent of the banks at a billion dollars or less. And is it true that this 90 percent of banks did not create the circumstance that we had to negotiate in 2008, what we call a collapse of the—an economic crisis or something of that nature?

Mr. OSTERMAN. Right. The crisis in 2008 involved much larger issues than the community banks.

Mr. GREEN. And given that the community banks, the term you are using now, I am using small banks, using my benchmark at a billion dollars—and I don't begrudge you at all for saying community banks, because that term has become very pervasive. But I have now switched, and I am working now to see what I can do for small banks, given that 90 percent of the banks are under a billion dollars.

And I want to work with legislation to help them, because I am also finding that most of the banks that are troubled now, possibly about to go out of business, are small banks. Is this a fair statement, more so than banks above a billion dollars?

Mr. OSTERMAN. We certainly have seen a consolidation of the industry, and when you look at the banks that have failed during this crisis, the vast majority are the smaller institutions.

Mr. GREEN. Do you find, as you are before Congress giving your testimony, that many of the questions that we ask, we should ask of ourselves? Because many times we ask you questions about regulations that we impose upon you that we seem to decry your enforcing?

Mr. OSTERMAN. The—

Chairman HENSARLING. Apparently, the gentleman will have to answer his question himself, because the time of the gentleman has expired.

Mr. GREEN. Thank you, Mr. Chairman.

Chairman HENSARLING. And the Chair now recognizes the gentleman from New York, Mr. King, for 5 minutes.

Mr. KING. Thank you, Mr. Chairman.

Mr. Alvarez, I would like to question you regarding the collateralized loan obligations (CLOs) and say at the start that I identify entirely with the remarks of Congressman Garrett.

As you know, the Fed has just issued a 2-year extension for the conformance period for banks that hold CLO debt. This comes nearly 2 months to the day that Governor Tarullo told this committee that Volcker's impact on the CLOs was the interagency working group's number one priority.

Given the time that has passed, I would have expected more. The conformance period extension may minimize the pain, but it certainly does not eliminate it.

Even with the extension, banks will suffer multibillion dollar losses. The OCC admits to $3.6 billion; other estimates place the number as high as $9 billion.

These are losses that will be incurred on performing assets solely due to the actions that the bank regulators have taken in applying the Volcker Rule. In fact, the expected losses on these assets are negligible.

So I have two questions.

First, do you believe that depleting bank capital by billions of dollars is a result that is consistent with safety and soundness regulation?

And second, this aspect of Volcker is clearly inconsistent with safety and soundness considerations in Section 13D1(j) of Volcker, which allows the regulators to permit activities that promote bank safety and soundness. So my second question would be, why don't you use this authority to grandfather legacy CLO assets that are on banks' balance sheets?

Mr. ALVAREZ. Let me start by putting the problem in perspective. There is approximately $300 billion in CLOs outstanding. That includes CLOs that would be exempt under the Volcker Rule and CLOs that would be covered by the Volcker Rule.

As Congressman Garrett pointed out earlier, any CLO that is entirely loans is exempt from the Volcker Rule requirements. It is only the ones that have nonconforming non-loan assets in the CLO.

So of those $300 billion, we think about a hundred—based on the call reports, about $105 billion worth of CLOs are owned by banking institutions. That is, of the 6,800 banks in the United States, something like 50 banks report that they own CLOs.

And then of those 50 banks, a handful of the very, very largest in this country own 90 percent of the CLOs. So this is largely a problem that is concentrated with a small number of very large institutions.

Now, what the Federal Reserve has done by granting an extension to, or by indicating it would be willing to grant, an extension for a couple of years, is it turns out that something on the order of 50 percent of the CLOs outstanding will mature or be repaid before the end of 2017. So much of the CLOs will be done by that period of time.

And as many people have testified before this committee, the CLOs that are owned by banking institutions have largely been performing. There are very few that are loss producing at this point. Having 2 extra years allows institutions more time to divest if they think that is appropriate, to conform the CLO to something that would be exempt from the Volcker Rule, and there is a variety of ways that could happen.

Mr. KING. The OCC estimates up to $3.6 billion in losses; others go as high as $9 billion. Is that healthy for the economy?

Mr. ALVAREZ. I think that the—

Mr. KING. And couldn't that force banks in effect to hold bargain basement sales?

Mr. ALVAREZ. I think the $3.6 billion estimate was assuming that an entire chunk of CLOs would default that no one really believes will default. That was an extreme example. And I will let the OCC

speak to that, but I think they were not predicting a $3.6 billion default.

And in fact, the representatives of the CLO associations have indicated that the CLOs are very well-performing and have very few losses in them. And I think that is historically accurate.

Mr. KING. So you do believe that this adds to safety and soundness of the banking community—banking institutions by allowing this to go in place after 2 years?

Mr. ALVAREZ. The Volcker statutory provision does not have an exception in it for actions that will cause losses. It allows a limited authority to grant an exception if it would, in fact—

Mr. KING. Are you saying you would not be allowed to make an exception under Volcker, that Volcker would preclude you from this?

Mr. ALVAREZ. Volcker does not have a grandfathering provision and it does not have an exception that allows us to cause institutions to avoid losses.

Mr. KING. You are saying it would preclude you from doing that?

Mr. ALVAREZ. That is right.

Mr. KING. I would have to disagree with that. I think Congressman Garrett disagrees also.

Mr. Chairman, I have a series of other questions on another issue. Could I submit them in writing to the panel?

Chairman HENSARLING. Yes. Without objection, that will be made a part of the record.

The gentleman's time has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you.

Chairman HENSARLING. Apparently, the Chair does not. He has been informed by the Minority side we are going to the gentleman from Minnesota.

The gentleman from Minnesota is recognized for 5 minutes.

Mr. ELLISON. Allow me to thank the chairman and the ranking member, and Mr. Foster as well. I know we all have busy schedules and I will try to be quick.

Ms. Fuchs, thank you for the work that you do. I think the CFPB does have a responsibility to ensure that people of color are not overpaying for autos.

What did the CFPB find in the price disparity studies by ethnicity and how significant are the differences?

Ms. FUCHS. The Bureau has one matter that is an enforcement matter that has been public, and in the materials related to the enforcement matter, it talks about the specifics of that matter. Other matters that the Bureau is working on are ongoing either investigatory or supervisory matters, and so there are details that can be shared at this time.

Mr. ELLISON. So you don't want to talk about the price disparities by ethnicity? You don't talk about whether there is a problem and how serious it is?

Ms. FUCHS. The Bureau hasn't done an analysis that looks across the entire industry and finds some number of disparity. We are looking at each individual lender that is engaged in indirect auto lending across their portfolio to assess whether there are dispari-

ties. We have been talking with the committee about the particular matter that—

Mr. ELLISON. Ma'am, I am trying to give you a chance to talk about your good work on eliminating disparities and you are declining.

Ms. FUCHS. I am—

Mr. ELLISON. Is that what you really want to do?

Ms. FUCHS. Perhaps I am not understanding the question.

Mr. ELLISON. Fine.

Ms. FUCHS. I apologize.

Mr. ELLISON. Somebody else, something else. I know that the regulators have increased enforcement against money laundering. HBSC has been fined $1.9 billion for transferring billions of dollars from Mexican drug cartels and for violating sanctions laws, doing business with countries like Libya, Sudan, Burma, Cuba, and Iran.

And I am glad that agencies are indicting money launderers, and I think that all those who are engaged in that activity deserve to be held accountable. But one of the things that I have become concerned about is how that regulatory system might be swinging a little too far, because what I have seen in my own district over the last 2 years is that money service businesses that send money to their families, particularly in Somalia, are having their checking and saving accounts closed by credit unions and banks.

I have a group of Iranian graduate students at the University of Minnesota who were told that their bank accounts would be closed, and I have people with Muslim names who are having their checking and savings accounts closed.

The difficulty is you have to stop terrorist financing. And the other difficulty is if you go too far in that direction, you close off good people just trying to do legitimate transactions.

I have tried to raise these issues before, and I would like to submit some things for the record: a Treasury blog post from December 23, 2011, entitled, "The Importance of Remittances Through Legal Channels to Somalia." And without objection, I would also like to submit a July 8, 2013, letter from the Department of the Treasury clarifying that college students from Iran can have bank accounts.

Mrs. CAPITO [presiding]. Without objection, it is so ordered.

Mr. ELLISON. Yes, thank you.

Maybe, Ms. Friend, you could discuss this issue a little bit. Has your agency been trying to provide training and guidance for your regulated financial institutions to enable them to better understand the rules regarding knowing their customers? And do they have any concern that in our zeal to obey laws to stop terrorism financing, we might actually be closing off legitimate transactions?

Ms. FRIEND. Congressman, I know the folks at the OCC have been in touch with your staff and we are concerned. We share concerns that if there are legitimate businesses that we are not asking banks to close off those accounts.

Essentially, it is a bank's decision who to do business with. What we direct them to do is to do due diligence and they need to have the proper controls to deal with whatever risks that they assess.

Some institutions, we have found, have decided that rather than go through the additional burden of providing the types of controls

that they believe are necessary, might decide that they are not going to bank a particular entity.

Obviously, with respect to Muslim names, if there is evidence that they are applying something in a discriminatory manner, that would be something we are concerned about and we are looking into it. So we are looking forward to a continued dialogue with your office.

Mr. ELLISON. I want to thank you for that. And just please do continue to assure financial institutions that they don't have to go beyond the line to meet the requirements of the law.

Thank you.

Mrs. CAPITO. The gentleman's time has expired.

I am going to recognize myself for 5 minutes for questions.

Ms. Fuchs, in my opening statement I talked about the qualified mortgage, and I am Chair of the Financial Institutions and Consumer Credit Subcommittee. We have done a lot of hearings on this.

And I am concerned that the borrower who is going to fit into this QM box is going to be the one who is least likely to be able to go to alternative sources to find mortgages besides their community banks or credit unions. What legal risks are associated with non-QM loans, in your opinion?

Ms. FUCHS. Thank you, ma'am, for the question. As I think you know, the CFPB—drawing the lines on what would be a QM and what would not be a QM was one of the most significant aspects of the rulemaking, and the rule was designed to incorporate the vast majority of mortgages that are being made within the QM category.

For mortgages that are outside the QM loan, we anticipate that those will continue to be made. In fact, I saw an article just yesterday that talked about something like 30 percent of banks would be looking at having lending programs that are outside the QM loan—the QM category.

For those matters, the banks are subject to following ability to repay requirements, and our—we anticipate that by doing a return-to-basic underwriting, as we had in the past, there actually will be fewer foreclosures. And that—

Mrs. CAPITO. You would agree that there is more legal risk associated with the non-QM loan, correct? And that is the way it is structured, the rule is structured.

Ms. FUCHS. The QM categorization does provide some protections for institutions. However, the liability is closely cabined, and outside of the QM category, if banks are engaging in an ability-to-repay calculus, then they should be in a good position with their solid underwriting.

Mrs. CAPITO. I think—and we have a survey here that says 33 percent of respondents indicated they would only make QM loans. So, a third of the lenders in this particular survey said that they would only lend in the QM box. I have a feeling it is actually a little bit larger than that. And I have heard—we have heard from community leaders who are actually exiting the mortgage lending space altogether.

You mentioned in your opening statement that before you do a rule you have a meeting and you talk about cost-benefits and have a report. Are those reports public?

Ms. FUCHS. Yes, the Bureau goes through several things in order to look at the costs, benefits, and impacts of its rules. From the small business panels that we convene, there is a report that results from that. The brief of panels are done as a partnership between CFPB, OMB, and the Small Business Administration. During the panels, we take input from representatives of small businesses in the specific area that we are writing a rule, and that—

Mrs. CAPITO. Yes, and I don't mean to interrupt that. I only have 2 minutes left.

Ms. FUCHS. No problem.

Mrs. CAPITO. Do you take into consideration the—did you talk to community bankers and credit unions and all those lenders in that space as well? Yes or no?

Ms. FUCHS. Yes, the Bureau does.

Mrs. CAPITO. Yes, and then that is public? Their response is public—the bankers?

Ms. FUCHS. The Bureau, in the course of its rulemaking, considers the impact of its rules on small lenders—

Mrs. CAPITO. Are those public reports?

Ms. FUCHS. It publishes that in its notice of proposed rulemaking for comments.

Mrs. CAPITO. Okay. We talked just a little bit about the remittance transfer rule. This is another one where a lot of people are exiting the business because of the onerous regulations imposed here. Some lenders do it for customer convenience; some do it for customer necessity.

And I would just say that it is making it more difficult and more expensive. I am not going to really ask a question on that, but lodge a concern.

Mr. Meeks and I have been working on a bill that would work on duplication and conflict of rules. And I know every 10 years you are supposed to go in and look at the conflicts. We are pressing for a shorter timeframe there.

Mr. Alvarez, do you think it would be useful to have a shorter timeframe in terms of looking at the rulemaking processes to the duplications? Because that was supposedly one of the goals of Dodd-Frank and I am not sure we have actually seen that.

Mr. ALVAREZ. That is an exercise that, by law, we go through, as Amy Friend mentioned earlier, under the Economic Growth and Regulatory Paperwork Reduction Act. It is every 10 years.

The Federal Reserve has an informal policy where we review our rules every 5 years. We are a little off schedule because we have been spending so much time on the Dodd-Frank Act, but we expect to get back to that schedule. So a shorter period of time of reviewing those rules is a perfectly good idea.

Mrs. CAPITO. Mr. Osterman, do you have the same—

Mr. OSTERMAN. Yes. I think sometimes it takes a while for the rules to be in place to see how they interact but a shorter timeframe is something we could do. Although, given the vast numbers that we have to go through, we are getting ready to go through a 10-year review right now, and as Ms. Friend indicated, she is the

head of the legal advisory group that is coordinating this effort, but with all the rules that are out there, to go through and review them all takes a long time in terms of going out and noticing those for the public—

Mrs. CAPITO. Right. Imagine you are a community banker and you are trying to deal with all this—

Mr. OSTERMAN. Exactly.

Mrs. CAPITO. You guys are dealing with it every day. It is your job. So I would encourage you to try to adopt that mindset, maybe, sometimes to try to help those folks out.

Next, Mr. Foster from Illinois is recognized.

Mr. FOSTER. Yes, thank you, Madam Chairwoman.

Ms. Friend and Mr. Alvarez, would it be possible to provide an estimate or a range of estimates of the additional losses that might be expected for banks which are forced to divest of the CLOs within the 2-year extension period, compared to the indefinite grandfathering that passed out of this committee?

Ms. FRIEND. Let me first just discuss the $3.6 billion number that was in our economic analysis. It came up earlier. And that was attributable to the divestiture of CLOs and CDOs and any other impermissible fund. And so when we looked at that estimate, it ranged from 0 to 3.6 because it really depends upon what the market reaction is going to be.

So I think it would be very difficult for us to estimate with a specificity exactly what the losses might be. Before we decided that we would take no further action than to support the Fed's conformance period, we looked at sort of worst case scenarios and believe that there would not be any significant impairment to any institutions' capital, at least in the national banking system, or to their earnings. And so, that is why we decided that this was consistent with safety and soundness.

But again, it really depends upon on what the market reaction is going to be once the banks start to sell these, or as they run off.

Mr. ALVAREZ. I have nothing to add.

Mr. FOSTER. Okay. Mr. Alvarez, on page eight of your written testimony you mention that the Federal Reserve is consulting with the FDIC on a regulatory proposal that would require the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding, long-term unsecured debt, in addition to the regulatory capital that they are already required to maintain. This is to facilitate the single point of entry resolution of these firms. Now, would this apply to all SIFIs or just banks?

Mr. ALVAREZ. That is part of the discussion, how far should it apply—whether it should apply just to the largest banking organizations or it should apply to SIFIs as well.

Mr. FOSTER. Yes, and would there be restrictions on who could hold this long-term debt? For example, could one SIFI hold—

Mr. ALVAREZ. That is a part of the discussion as well.

Mr. FOSTER. Okay. And how does this relate to the contingent capital discussions that I take it are also ongoing? We have been promised many times that well, we are in the process of thinking about contingent capital, it is getting closer.

And I was wondering what your view was of the status of contingent capital. As you are well aware, the European regulators are

far ahead of us on contingent capital and it seems to be fairly successful.

Mr. ALVAREZ. This is slightly different. The contingent capital is free—

Mr. FOSTER. Right, it triggers—obviously, there is a regulatory trigger, not as a part of resolution.

Mr. ALVAREZ. Correct.

Mr. FOSTER. Could the mechanisms be similar—the conversion of debt to equity under prescribed conditions. And so would this be higher—or above or below in the capital stack of these firms—the additional—

Mr. ALVAREZ. I don't know the answer to that question. It is meant to be complementary. It would be after resolution—useful mostly after resolution rather than the convertible securities, as you point out, which is—convertible debt, which is mostly before.

We are participating pretty actively in the international discussions. We think that is a fruitful way to consider the convertible instruments because it depends—the trigger there becomes a very important factor. And so should the trigger be a regulator, should it be a market event? Should it be a home regulator, post regulator? There are lots of variables there. It is a much more complicated instrument than the long-term debt.

Mr. FOSTER. Thank you. Is there a schedule for that? Do you have any idea when we will actually see a concrete proposal so we will be able to say what the trigger mechanism—the preferred trigger mechanism is?

Mr. ALVAREZ. I don't have a concrete date for you. It will be soon. It will be something, though, that we will be very interested in public comment on because this is a very important effort, we think.

Mr. FOSTER. Okay. Thank you.

That was my last question. I yield back.

Mrs. CAPITO. I recognize Mr. Royce, the Chair of the House Foreign Affairs Committee.

Mr. ROYCE. Thank you, Madam Chairwoman.

I wanted to ask Mr. McKenna a question. It is about a piece of legislation that I and Jared Huffman introduced, the Credit Union Residential Loan Parity Act. And what that bill does is to remove non-owner-occupied one-to-four-unit dwellings from the calculation of the member business lending cap currently imposed on credit unions.

And this reform really has two advantages in terms of increasing the capital available to lend to small businesses and the availability of needed rental housing as a consequence if this change was made. And I was going to ask you, Mr. McKenna, does the NCUA have any comment on this legislation?

Mr. MCKENNA. The agency has reviewed that piece of legislation and we do not have any safety and soundness concerns with it.

Mr. ROYCE. Could you pull the microphone a little closer?

Mr. MCKENNA. We have reviewed that piece of legislation and we do not have any safety and soundness concerns with it.

Mr. ROYCE. You don't have any concern about safety or soundness from that standpoint?

Mr. MCKENNA. Not with that piece of legislation, no.

Mr. ROYCE. I appreciate that very much.

I also wanted to ask you, on a related note, the NCUA has put forward a new proposed risk-based capital rule for credit unions over $50 million in assets, and I am concerned that risk weights applied to residential mortgage loans and member business loans under the proposal do not actually reflect the risk nor are they comparable to the system for community banks.

And I will just give you an example. If you look at the delinquency rates, first of all, on these loans from the latest data available, credit unions have delinquency rates which are one-quarter to one-half that of banks. The proposed rule would apply risk weights that are double the comparable Basel weights.

And that is the thing that stands out to me—the rate being double. Why does the proposed rule regarding risk-based capital deviate so much from the FDIC standards for community banks? That was what I was going to ask you.

And do you have concerns that these risk-weightings could hinder credit union lending to homeowners or small businesses or even churches? You have these niches out there and this would be quite a change. But I would like to explore that with you. Go ahead.

Mr. MCKENNA. As you pointed out, it is a proposed rule that we issued in January of this year. The comment period closes in May. We have already received lots of comments on the risk weights and that is something that the NCUA board is going to be looking at.

The basic thrust of your question was whether our rule is comparable to the FDIC's rule. And in general, taking into consideration the unique nature of credit unions and other factors, we think it is comparable to the FDIC rule. However, we are reviewing the risk weights to see if they make sense to credit unions.

Mr. ROYCE. Yes, because the data behind those delinquency rates—one-quarter to one-half—if you look at the September data, it shows real estate loans last September—a delinquency rate of 1.22 versus 4.77. If you looked at commercial loans, it would be 0.35 versus 0.55.

So the part that just stands out is if you end up with double the rate then the question is, do you end up sort of shorting capital that otherwise would be available for small business lending and so forth.

So my hope would be to work with you—we have a good working relationship—as we go forward to try to make certain at the end of the day we don't disproportionately impact capital that otherwise would be available for either home ownership, small business lending, and so forth.

Mr. MCKENNA. We hope to work with all stakeholders to make the final rule more effective.

Mr. ROYCE. Thank you very much.

And Madam Chairwoman, again, I appreciate it.

Mrs. CAPITO. I now recognize Mr. Sherman from California.

Mr. SHERMAN. Thank you.

I would like to pick up on Mr. Royce's questions. I am also concerned about these rules on credit union capital. As I understand it, it would impose a Basel-like capital regime on those who already face stringent capital requirements.

And I will ask Mr. McKenna, it seems that the rule provides for tougher rules for credit unions than are applied to community banks under the Basel system even though credit unions have historically been even more risk-averse. Are the rules tougher than that are imposed on community banks?

Mr. MCKENNA. Congressman, some of the risk weights are different than the ones that the FDIC has.

Mr. SHERMAN. And I hope you would take into account the fact that the number one problem that small businesses, I think, have in all our districts is they can't get capital. They can't get a loan. We had Jamie Dimon in here saying he couldn't find U.S. businesses to lend money to, so he sent the money to London where it was eaten by the Whale.

Every one of us here could list a hundred businesses that can't get business loans, and so I hope you would take that into account in determining what weights should be applied.

Supplemental capital is an issue that credit unions have been concerned about. They would like the authority to pursue supplemental capital, since their tier-one capital is generally now limited to retained earnings, and of course they cannot, will not issue stock.

I believe your agency has indicated support for supplemental capital, which credit unions can't use for leverage ratio purposes without a change in the Federal Credit Union Act. Why isn't your agency coupling its support here in Congress for supplemental capital for tier-one purposes with the risk-based capital proposal?

Mr. MCKENNA. As you point out, it is currently a proposed rule, and the issue of supplemental capital will be something that we look at when we finalize the rule and listen to the comments.

Mr. SHERMAN. So you may be putting the two together?

Mr. MCKENNA. It is a possibility.

Mr. SHERMAN. Okay.

Now I would like to shift—I know a number of my colleagues have talked about this "Operation Choke Point." I would ask unanimous consent to put in the record an article by William Isaac entitled, "DOJ's Operation Choke Point: An Attack on Market Economy."

Mrs. CAPITO. Without objection, it is so ordered.

Mr. SHERMAN. Thank you.

I guess, Mr. Osterman, you have said that you are cooperating with DOJ on this. Is it being limited to—are you trying to choke off entities that had been indicted or convicted of crimes, or what is the target of Operation Choke Point?

Mr. OSTERMAN. Congressman, I am really not in a position to answer that because it is not an FDIC program. Again, we have been providing information to the Justice Department for their actions, but we—

Mr. SHERMAN. Okay. But it is your examiners that are putting the pressure on banks to do to certain U.S. businesses what I spend most of my time trying to get done to the government of Iran, and that is deny them access to the U.S. banking system. Are your examiners pushing banks toward cutting off any U.S. businesses that are—particularly those engaged in consumer credit?

Mr. OSTERMAN. The answer to that is no. What we have—

Mr. SHERMAN. So we wouldn't hear testimony from those who deal with your bank examiners saying that they were told, "Well we are going to look at you more carefully unless you cut off this-or-that business?"

Mr. OSTERMAN. As I have said before, we have actually put out a policy statement on this issue to make it very clear from the very top that as long as financial institutions are properly managing their relationships and the risks, they are neither prohibited nor discouraged from providing these services.

And we have actually had the head of our examination staff talk with our regional offices and our field offices about this. And so, to the extent that this message isn't getting through, we are certainly happy to hear it and try to get that message correct.

Mr. SHERMAN. I think you need to get the message through.

And, Ms. Fuchs, I look forward to your agency regulating properly consumer lending, rather than having—

Mrs. CAPITO. The gentleman's time has expired.

Mr. SHERMAN. —this get done behind the scenes without the Administrative Procedure Act.

I yield back.

Mrs. CAPITO. Thank you.

Mr. Pearce is now recognized.

Mr. PEARCE. Thank you, Madam Chairwoman.

And I thank each one of your for your presentations today.

Ms. Fuchs, you had mentioned that you are hard at—the CFPB is hard at work making sure that consumers have better information for making financial decisions. Later, you pointed out that you are required to consider rural areas. Again, I point it out every time I have the opportunity with someone with your agency that you—your original definitions of rural versus urban put 2 counties, one of 8.5 people per square mile that compares to 70,000 per square mile in New York. You would lump them together.

And then the other one is 6 people per mile, and the one with 6 people per mile has a per capita income of about $25,000. So I am not sure exactly how that is that you are going to give consumers better information when you have missed the mark that far.

I know you have done a 2-year study, but I don't know many institutions will go in to lend money for the long term based on 2-year changing regulations. I don't really have much belief that I would get different answers than I have gotten before so I will just add a quote from one of the bankers talking about being hurt by the real definition, which lets you know how you are cutting against the grain, really not providing the security and not providing what it is that you declare in your statement.

A small banker in Alamogordo, New Mexico, says, "If I stop lending—he is being hurt by this rule definition—my community will not have a bank to meet their needs. I am a small bank investing private capital to service micro needs. Wells Fargo won't make a loan for an ice maker for a small business in New Mexico but I will."

And that is the sort of thing that we run into. And another comment is regarding the purchase of trailer houses, mobile homes, manufactured houses, whatever category you put it in, and it ap-

pears the CFPB doesn't declare that to be quite up to the standards that you would like. So your positions on qualified mortgages and also balloon loans make it very hard for consumers to borrow money for manufactured housing.

And yet, that is 50 percent of the housing in my district, and so you are doing exactly the opposite of what you declare, just as a point of reference so you can go away and know that I have at least said it.

Mr. Osterman, I was actually intrigued by your comments. As Mr. Westmoreland was wrapping up, you were talking about Operation Choke Point, and do you all—as you are going in there, you said that it is against some State laws. Do your regulators know all 50 State laws? Do you differentiate? Tell me a little bit about how you avoid getting into areas where that is legal and those where it is not?

Mr. OSTERMAN. Again, what we do is supervise our financial institutions, and our efforts are not targeted at legitimate businesses operating in compliance with the law. So our efforts are focused on making sure our institutions are being run in a safe and sound manner and that if there—and I think there is a recognition that there are certain types of—

Mr. PEARCE. I understand that there are certain types of things that are wrong, so do you bring criminal investigations? It says in an article that you bring criminal investigations—you, DOJ, FTC, USPIS, and FBI, and it includes the FDIC there. So you would bring criminal investigations too?

Mr. OSTERMAN. We would not be involved in criminal investigations—if we see criminal activity, we would make a referral to the Department of Justice—

Mr. PEARCE. You would make a referral when somebody gets so far out of bounds? There are things that abridge the law and abridge the themes of common decency.

Mr. OSTERMAN. If there is illegal activity, we will make—

Mr. PEARCE. Yes. I guess that would bring me to my point—my recurring point with the FDIC is that you all had a supervisory role over MF Global, and yet no criminal charges were brought. That was $1.6 billion taken from customer accounts illegally. The Huffington Post said, "The lack of charges add to the government's sad track record of toothlessness since the financial crisis."

And later in that article it says, "Apparently MF Global didn't intend to take money from clients." Now, I was not aware that intention was exactly the best decider, so we continue to see that certain scale of institutions, certain connected institutions are targeted and others don't even get criminal charges.

I yield back my time.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

I would like to take this opportunity to extend my congratulations and welcome to my friend and colleague, Mr. Horsford, who has joined us. I can state unequivocally that there is not a single member of this committee happier than me that there is somebody less senior than I am.

[laughter]

I would also like to congratulate him on the fastest and shortest brevet promotion to ranking minority member in the history of the community.

Ms. Fuchs, you have come in for some criticism today and before—some warranted, some I suspect not so much. One area where you are generally not criticized at the Bureau is the manner in which you deal with servicemembers through Ms. Petraeus' office. I never miss an opportunity to congratulate the work of the agency in that regard.

Also I think, generally speaking, people extend to you plaudits for the way in which you have, generally speaking, listened. You, I mean, of course, figuratively.

Lots of stakeholders from our district may be critical of final rules, but most of what we have heard for the last year or two is, "We complained and they sat down and they listened."

One of the ways in which you are able to do that with respect to consumers and banks and credit unions is you actually have advisory boards that kind of formalize your ability to listen. I would very interested in just a sentence or two about how that makes you better at your job. And secondly—two-part—given that Mr. Pittenger has introduced an outstanding piece of legislation—sir, I compliment you—in the form of H.R. 4383, that would create another small business advisory committee for the CFPB for other entities that you regulate, like appraisers and title insurers, might we look forward to your active support of that to help you keep doing the good job of listening that you have done in these other areas? Your turn.

Ms. FUCHS. Thank you so much, sir. I appreciate your comments about the CFPB's outreach efforts, and I should—and we have found that both the Credit Union Advisory Committee and the Community Bank Advisory Committee have been very, very helpful for the CFPB. The CFPB writes rules across the entire financial services consumer finance industry, although we only examine larger banks and nonbanks, and so having those advisory committees has been helpful to us.

With respect to the legislation, the CFPB doesn't take positions on pending legislation. I should say, however, as I mentioned earlier, we are the only bank regulator and one of only three Federal agencies that subjects itself to the small business panel requirements, and we have found that extremely useful, and our economists would say it has been very valuable to hear from small businesses who would be affected by rules that we are planning to propose directly about those proposals. And so that has been a very, very useful process. Thank you.

Mr. HECK. Thank you.

And my compliments again to Mr. Pittenger, for the legislation.

Mr. Osterman, it is axiomatic that piles of cash are an inherently bad thing. I am just finishing up watching the Breaking Bad series and there is that scene in the storage room where the six-foot-by-six-foot-by-four-foot pile of cash is kept in the little room. There is nothing good about that; nothing whatsoever.

And that is why, sir, Mr. Perlmutter and I have been working so hard and so aggressively with Treasury and the Financial

Crimes Enforcement Network (FinCEN) to issue guidance with respect to providing access to banking services to legally constituted marijuana businesses in Colorado and Washington, because it is a public safety issue. Because we have to keep marijuana out of the hands of children and we have to keep cash out of the hands of gangs and cartels.

And, sir, Happy Valentine's Day. On that very day, FinCEN did issue guidance. Please tell us how your agency will now take that work to the regional level and to the examiners so that they can provide the necessary implementation advice and guidance and get on with this in the interest of public safety.

Mr. OSTERMAN. Congressman, we expect the banks to follow the FinCEN guidance, including the new guidance that has been issued and its new SAR requirements for marijuana-related businesses. But at the end of the day, it is up to the bank to accept the business as a customer after weighing the risks associated with the customer relationship.

Mr. HECK. I understand that. The question is, what have you done now to take that guidance regionally to your examiners and say, "Here is our new guidance, that if you instruct things to operate within this, that is acceptable." What have you done to take the next step?

Mr. OSTERMAN. Again, the examiners are aware of the FinCEN guidance. It is up to the bank to make the call as to how it is going to operate.

Mr. HECK. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Posey, for 5 minutes.

Mr. POSEY. Thank you very much, Mr. Chairman.

Thank you all for appearing here today.

Mr. Alvarez, I would like to state a few facts, as I understand them, about the Volcker Rule and how it was adopted. Let me assure you that when I am finished, you will have more than adequate time to explain.

Dodd-Frank codified the Volcker Rule as 12 USC-1851. As I believe Mr. Garrett alluded to, Section 18-51G specifically states that the rule does not prohibit any bank from securitizing a loan.

Now, when the proposed Volcker Rule regulations, 76 CFR 215, were issued on November 7 of 2011, there was no discussion as to whether collateralized debt obligations (CDOs) and collateralized loan obligation (CLOs) would be considered proprietary trading. In fact, sub-part A of Section 13 specifically said that securities consisting entirely of loans were not proprietary trading.

Yet, when the financial regulations were issued on December 10, 2013, regional and community banks suddenly discovered that regulators had, in fact, made significant changes to the treatment of CDOs and CLOs and that the banks would have to get them off of their books in less than a year. Given the industry's surprise with the final rule, I am trying to understand how this regulation morphed from the proposed rule to the final one, because there appears to be something seriously wrong here.

Furthermore, the financial industry submitted more than 18,000 comments during the notice and comment period for the proposed

regulations. Yet none of them raised a concern as to how CDOs and CLOs would be treated.

That tells me that if an important piece of regulation receives no public attention during a comment period but a great deal of attention afterwards, you have to wonder whether the proposed rule was, in fact, adequately, fairly, and reasonably described when given for public comment, if it was described at all. So my question to you is, would you please give me a specific citation in the proposed rule where the treatment and CDOs and CLOs were set out?

Mr. ALVAREZ. The proposed rule had something on the order of a dozen questions about asset-backed securitizations, including CDOs—asked about how the ownership interest should be defined, how the instrument should be treated under the Volcker Rule. As you pointed out, the proposal and the final rule both exempt asset-backed securitizations that are backed entirely by loans.

The issue is a very small number of banks own CLOs that are not backed entirely by loans, that indeed are backed by loans and other securities that are not loans. As I mentioned, there seemed to be about 50 banks in that group.

I think that may explain why there was no comment received on it. It is a very small universe of institutions that are affected by this among the thousands that are affected by the Volcker Rule.

We have acted in a way that gives these institutions extra time. They have an opportunity to conform the investment in a variety of ways, short of divestiture.

Some may choose to divest. As I mentioned, at least half of the CLOs are going to mature on their own terms during the period of time that we have given the institutions. So this problem is one that is very, very small.

Mr. POSEY. So you are telling me that securities, consisting entirely of loans, are not proprietary trading then. You are telling me absolutely, unequivocally, without any shadow of doubt, that they are being treated properly. If they are entirely consisting of loans, then they are not considered proprietary trading, correct?

Mr. ALVAREZ. If I could make a small modification of what you are saying, there are two restrictions in the Volcker Rule: one on proprietary trading; and one on ownership of covered funds.

The issue you are raising is about the ownership of covered funds. And, yes, it is true that if it is an asset-backed securitization entirely by loans it is not a covered fund and is not covered by the Volcker Rule.

Mr. POSEY. Thank you. I will hold you to that. Thank you.

Thanks, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlemen from Nevada, Mr. Horsford, for 5 minutes.

Mr. HORSFORD. Thank you very much, Mr. Chairman.

First, I want to thank the witnesses for being here today and for providing so much valuable information and expertise on this subject.

I started my service here in Congress on the Oversight and Government Reform Committee, where I learned to value the assessment of the U.S. Government Accountability Office, so I want to start with a 2013 GAO report entitled, "Financial Crisis Losses and

Potential Impacts of the Dodd-Frank Act," and I would like to ask unanimous consent to enter this into the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. HORSFORD. Thank you.

The GAO report noted that, given the tremendous cost associated with the financial crisis, reforms only have to reduce the likelihood of another financial crisis by a very small percentage in order to offset the cost to the industry. The GAO identified as much as $13 trillion lost in economic output and $9.1 trillion in wealth lost by U.S. homeowners.

As a resident of Nevada, I can tell you when I go back home to my district, I see the devastating impacts and toll that the housing crisis took on our constituents and the people throughout our State. Now, no one supports excessive, burdensome regulations. But we also need appropriate regulatory oversight to both protect the good industry players from the bad actors as well as to help consumers who need a fair playing field in which to operate.

So my question is for the panel.

Mr. Alvarez, what efforts does your agency undertake in attempting to reduce any unnecessary burden when creating new rules and regulations, and what processes and procedures are in place for you to honor that commitment?

Mr. ALVAREZ. As I described in my testimony, the Federal Reserve meets with affected parties in advance of designing rules in the most significant cases. We seek public comment in all of our rulemakings, including public comment on alternative approaches, on ways to reduce burden, we invite comment on the cost and burdens of the rule that we are putting forward. And so, we follow that process.

In addition to that, in order to ensure that there is input from community bankers in particular, we have set up various councils across the Federal Reserve System—one in each of our 12 districts—with representatives from the local banking communities to inform us of the costs and burdens of the rules we are putting forward.

Then representatives of those councils meet with our Board of Governors here in Washington and pass on those concerns and have a chance to input their own concerns. So we do quite a lot of outreach, and we do quite a lot of work with institutions to try to make sure that within the bounds Congress has set for us in the statute that we are implementing, we adopt alternatives that are the least burdensome.

Mr. HORSFORD. So, Mr. Osterman, how, then, do you get feedback from both the industry and consumer side? Is it balanced? And fundamentally, is it different from the way past Administrations have approached that input?

Mr. OSTERMAN. We seek notice and comment, as Mr. Alvarez has stated. We also will seek input even before rules are promulgated, on occasion, to get input. But certainly as we go through that process and we issue the notice of proposed rulemaking, we get the comment from the industry. We look at ways to minimize—

Mr. HORSFORD. What about consumer groups?

Mr. OSTERMAN. —the burden, and consumer groups are part of those groups that do provide us comments. And really, I don't think

it is any different from the process that has been in place for many years under the Administrative Procedure Act.

Mr. HORSFORD. Okay.

Ms. Fuchs, how do you also obtain the perspective of communities like mine that have been heavily and disproportionately impacted by the failure of a lax regulatory oversight that helped contribute to the loss of so much wealth for average, middle-class homeowners?

Ms. FUCHS. The CFPB is very conscious of the history that led to the creation of the Bureau, and in our work, in addition to some of the formal procedures I talked about in my written testimony, the Bureau has engaged in very, very regular interaction across the country with all sorts of communities. Virtually every month, we do a field event in a different State across the country. And while we are there, in addition to a public hearing, we also meet with community groups, community bankers, and credit unions.

Mr. HORSFORD. Thank you.

Thank you, Mr. Chairman. I look forward to continuing to work on these issues.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Osterman, my first comments or questions would be to you. A couple of times today you have already mentioned that, with regards to Operation Choke Point, the FDIC was working with DOJ and providing some information. Are you aware that the Division of Depositor Consumer Protection actually loaned two attorneys for a period of time to Operation Choke Point?

Mr. OSTERMAN. No, I am not, sir. I don't believe that is correct.

Mr. LUETKEMEYER. I have a copy—or I am aware of a copy—of an internal memorandum that was produced for Chairman Issa that confirms that fact. And in talking with some of the executives at the FDIC, they confirmed that fact, as well, to me last week.

So knowing that, and putting that fact before us here, I thought the mission of the FDIC was to work and be concerned with the—to ensure the safety and soundness of an institution. How do you rationalize loaning two of your examiners to the DOJ for Operation Choke Point, whose sole purpose is to run the non-deposit lenders out of business, a safety and soundness issue for the FDIC?

Mr. OSTERMAN. Again, I am not aware of that. But assuming you are correct in terms of what you are proposing here, as I have indicated before, our efforts aren't targeted at legitimate businesses. What we are looking at is making sure our banks are running in a safe and sound manner.

In terms of the Department of Justice, if they are involved in trying to stop illegal activity and they seek our assistance, we generally would provide assistance to them so that activity could be addressed.

Mr. LUETKEMEYER. Mr. Osterman, I used to be an examiner as well. I am still involved at arms length, probably, at a community bank as well. So I have been on both sides of the table on this issue. I understand what goes on.

But by the same token, I am not supporting those entities that are illegal or are doing illegal things. I support any activity that you engage in to get those—to ferret those out and get rid of them.

The problem is we are going the wrong direction. We have allowed the pendulum to sway way too far. Operation Choke Point is a perfect example of regulatory stuff going amuck.

I have here an excerpt from a letter dated February 26, 2014, from a banker to one of these nondeposit lenders closing his account: “We are unable to effectively manage your account on a level consistent with the heightened scrutiny required by our regulators for money service businesses.”

Now, this is after the fall policy statement that you made. This is still going on. What is heightened scrutiny? What are they referring to?

Mr. OSTERMAN. I am not quite sure what they are talking about. I can tell you that our efforts are focused on making institutions aware of risks that can be involved. But as long as the institutions are managing those relationships and the risks, they are neither prohibited or discouraged from providing those services. So—

Mr. LUETKEMEYER. Mr. Osterman, we have a statement from one of your examiners that says that he doesn’t believe that non-deposit lenders have a moral right to exist. That is completely out of line.

Your agency has no right to make that judgment on any business. Not only do we have a shadow banking system, we seem to have a shadow regulatory system as well.

If you have regulators out there who are working in cahoots with the DOJ, who are still being punitive with regards to my letter of February 26th, after your stuff, and the moral judgment statement that is made, something has to change. Would you be willing to work on and put in place a safe harbor for these non-deposit lenders?

Mr. OSTERMAN. I think that it is up to the non-deposit lenders to basically create a situation where the banks can be comfortable with the fact that they are being operated in a way that is not illegal or creating high risk to the institution.

Mr. LUETKEMEYER. Mr. Osterman, you are regulating these entities. You are the one who is coming down on the banks and saying, “Don’t do business with these.”

My banker association was in just a couple of weeks ago, and one of them made the comment that, “I was doing business with one of these non-deposit lenders and I went by—and I will still—there was no problem with them, but the FDIC kept nitpicking me to death and I just finally got rid of them, and suddenly all my problems went away.” That has to stop.

I think these folks need a safe harbor where you will give the banking industry a way to work with these folks and protect them from your operation. Do you agree?

Mr. OSTERMAN. I think there needs to be dialogue here so that we can understand what the issues are and try to address them.

Mr. LUETKEMEYER. Okay.

Quickly, Ms. Fuchs, I am very concerned because the CFPB is about ready to jump in this area as well with your rules. Mr. Cordray was in front of this committee not too long ago, and he

made a statement to me that he agreed that non-deposit lenders have a space that they need to be in and he would support them.

On April 25, 2012, he also said the CFPB is not in the business of product banning. I am going to be watching very carefully to see how you address that position of your Director and still allow these entities to exist.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman.

Mr. Alvarez, are you aware of whether the Fed is required to open up their advisory committee meetings to the public or to Congress?

Mr. ALVAREZ. The Federal Advisory Committee is a statutory organization and is not required to be open to the public.

Mr. DUFFY. Do you know why not?

Mr. ALVAREZ. It allows the members of that committee—which are representatives of the banking industry—to give their candid views to the Board on monetary policy and on supervision.

Mr. DUFFY. So it is monetary policy issues that come up that require some secrecy about what the Board is doing, right?

Mr. ALVAREZ. Correct.

Mr. DUFFY. Okay. Does the CFPB have a seat at the table talking about monetary policy?

Mr. ALVAREZ. No.

Mr. DUFFY. No.

Ms. Fuchs, is it your position that the CFPB is not required on the FACA to open up their meetings to Congress or the public?

Ms. FUCHS. The CFPB is an entity within the Federal Reserve System, and the Federal Advisory Committee Act (FACA) does not require the entities of the Federal Reserve system to comply with FACA.

Mr. DUFFY. This is the Federal Reserve System, right? So you are saying that you are an integral part to the cause and the reason why the Fed is exempt, which is setting monetary policy?

Ms. FUCHS. No, I am talking simply about the way the law is structured. I am not talking about the reason that Congress put that in place.

Mr. DUFFY. So are you prohibited from opening your meetings up to the public or to Congress?

Ms. FUCHS. With respect to the Consumer Advisory Board, the Bureau has certain sessions that are open to the public and I am aware that—

Mr. DUFFY. Listen to the question. Are you prohibited at the CFPB from opening up your meetings to the public?

Ms. FUCHS. We are not prohibited.

Mr. DUFFY. So you can open them up if you want to; you just choose not to.

Ms. FUCHS. The Bureau has certain meetings which are open to the public—

Mr. DUFFY. That is not my question. You choose to shut down some of the meetings, right?

Ms. FUCHS. And it is my understanding, as well, that members of the committee staff have attended those public meetings.

Mr. DUFFY. And those meetings aren't discussing monetary policy, right?

Ms. FUCHS. Not that I am aware of.

Mr. DUFFY. And those aren't meetings discussing covert operations in the CIA as well, right?

Ms. FUCHS. Not that I am aware of.

Mr. DUFFY. Okay. I have a riddle for you: What do tap water, your glasses, and the Consumer Financial Protection Bureau all have in common?

Ms. FUCHS. I do not know.

Mr. DUFFY. You don't know? There was a blog 3 years ago, April 6, 2011, on the CFPB Web site, and the answer is, they are all better when they are transparent.

Dirty glasses are annoying, dirty water is annoying, and a dirty CFPB is really annoying. And if you are not transparent, which you have claimed the CFPB would be and you are not, that is of great concern to this committee.

Look—the Credit Union Advisory Council meeting. No agenda. No notice of meeting. And a six-page summary of just glossary facts of what took place.

You have a Community Bank Advisory Council meeting. No agenda. Nine pages of very glossary ideas of what took place in the meeting.

The FDIC—Mr. Osterman—they have a similar meeting and they give an agenda; they give 20 pages of pretty detailed summary of what takes place in the meeting. And you are talking about the same issues.

FDIC—full disclosure with an agenda. CFPB, not at all.

You look at the Academic Research Council—no agenda. Do you know how long the minutes were from that meeting? It was two pages, one was a cover page and the other was barely a paragraph from the minutes.

And the CFPB comes in here and says, "We are open. We are transparent. We want to disclose."

I would suggest that you use your discretion and you open up these meetings. Let us see what kind of advice you are getting, and who is giving the advice. I think that would serve the CFPB well, it would serve this committee well, and it would serve the public very well if you did that.

I would just note that the Credit Union Times, on September 26, 2013, in an article said, "Give public access to more of its meetings and hearings to increase transparency." And that was in relationship to the CFPB.

If you want to get buy-in from this committee, your lack of transparency in the face of all the claims that were made about how transparent you would be with little cute jokes and blog posts about how wonderful it would be at the CFPB, you haven't met the standard. You haven't met the standard that was set by Elizabeth Warren.

Also in that same blog post it said, "Last month we blogged about our commitment to making sure it is always sunny at the CFPB."

Ms. Martin, in her testimony last week, I am sure she would say, "It is not always sunny at the CFPB." I think she actually testified, "It is a nightmare at the CFPB."

Let's open it up. Let's air it out. Let's have the transparency that you all promised.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlemen from New York, Mr. Grimm, for 5 minutes.

Mr. GRIMM. Thank you, Mr. Chairman.

I would like to follow up where Mr. Luetkemeyer left off, with Mr. Osterman. This Operation Choke Point gives me tremendous concern because it can certainly be Federal agencies like DOJ and others using a cloak of law enforcement to weed out and combat fraud and intentionally harming lawfully operating businesses.

Listen, anyone who is not doing the right thing, not following the law, we have to get rid of them. But you can't put the standard of "guilty until proven innocent." And in your last comment you said that these payday lenders and store fronts, non-deposit lenders, they have to meet this heightened standard, which means they are already assumed guilty. That is not how this works.

I just want to be clear: If payday lending is going to be deemed illegal, the Congress will say so, not your agency. Are we on the same page there?

Mr. OSTERMAN. Yes.

Mr. GRIMM. Okay. Because it doesn't seem that way.

My understanding is the FDIC has a list of businesses that are on a heightened scrutiny list. That, in and of itself, causes me some concern.

My question is, I understand that if the DOJ requests your assistance you are going to give that assistance. Has anything about Operation Choke Point caused you concern enough to maybe ask some questions of DOJ and say, "Hey wait a minute, you know, we want to be helpful but we may be breeching our own fiduciary responsibility?" Is there anything that has given you concern about Operation Choke Point?

Mr. OSTERMAN. We have operated entirely consistent with our statutory mission in providing assistance to the Department of Justice—

Mr. GRIMM. But my question wasn't whether you were within your statutory obligations. My question was, has there been anything that has given you concern? Has there been anything that has given you concern where you think maybe something isn't appropriate, that you may be overstepping a line?

Mr. OSTERMAN. To the extent that we understand DOJ is seeking to stop illegal activity, there is not anything inappropriate there. And in fact, you talk about this list of high-risk activities. That is a list that the payment card industry has created themselves. It was a list that we put in our Supervisory Insights Journal a few years ago. And it basically is a list of high-risk activities that tend to have a higher incidence of fraud or illegal activity associated with those, so—

Mr. GRIMM. Let me ask you this question. Let's talk about civil investigative demands (CIDs) for a second. It has been reported

that at least 50 banks and third-party payment processors have been given these CIDs as part of this operation.

Before issuing a CID, does the FDIC—do you request of DOJ that they give you any type of information to ensure that it is credible and that it is a reasonable cause to conclude that there was a substantial likelihood that the targets had, in fact, engaged in some kind of fraudulent activity?

Mr. OSTERMAN. I am not familiar with the CID acronym, but to the extent that DOJ is doing an investigation, that is their investigation. We have been—we would provide them, respond to questions, that type of thing, but that would be their investigation. I don't think they would come to us on that.

Mr. GRIMM. I just want to be clear then, whatever DOJ asks for, the FDIC provides without asking any questions. You don't do any internal investigation of any sort, so whatever DOJ asks for, you pretty much provide?

Mr. OSTERMAN. No, I don't—that is not correct. It would have to be a legitimate law enforcement activity that we would be supporting DOJ on. We would cooperate—we cooperate with other agencies as well in ensuring that the statutory mission of the agency is fulfilled.

Mr. GRIMM. As far as you know, the coordination involvement, does it involve any attorneys general from other States with Operation Choke Point?

Mr. OSTERMAN. I don't know the answer to that question.

Mr. GRIMM. How about any other consumer advocacy groups? Has there been any communications or involvement with consumer advocacy groups?

Mr. OSTERMAN. Again, I am not aware of the answer to the question.

Mr. GRIMM. I am asking specific with the FDIC, not with DOJ.

Mr. OSTERMAN. Right.

Mr. GRIMM. As far as you know—

Mr. OSTERMAN. Right. I am not aware of it myself.

Mr. GRIMM. You are not aware of any?

Mr. OSTERMAN. No.

Mr. GRIMM. Okay.

I yield back. Thank you.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I really appreciate you holding this hearing.

And I appreciate the witnesses being here and their time. We are in a difficult time in this economy. There are still a lot of jobs that need to be added, and the way you have to add those jobs is you have to figure out how to finance that growth of our economy, and the financial sector has done that.

I am really concerned about a couple of things that I want to talk about and ask some questions about. The Operation Choke Point really has me worried about the overreach of government and government shutting down properly licensed State businesses with which they just don't agree.

And it gives me cause for concern about other businesses, whether they be opposed by folks on the left or the right. Government can really abuse its power and it really worries me.

I have a testimonial from an Ohio-based company that has had a 20-year partnership with a financial institution, and with no warning they got a call just a few weeks ago and the bank is going to terminate their banking relationship after a 20-year relationship because of reputational risk. And that reputational risk is driven by our regulatory policy and regulatory pressure, and I am really worried about that.

So I want to ask the FDIC whether, Mr. Osterman, you believe there should be a safe harbor? I know somebody has brought this concept up to you, but why shouldn't State-licensed businesses have a safe harbor to know that they are going to be able to keep their relationships?

Mr. OSTERMAN. I think as long as you have a situation where the entity is operating in a legal fashion, that should take care of addressing the issue. What we have seen in the past is there are certain types of businesses that have been viewed as high-risk by the payment card industry and others because of the higher incidence of fraud or illegal activity, and to the extent that—

Mr. STIVERS. Sure. And I just hope your agency will put in writing what you just said, that if you are operating under a State license legally, that you—that is a safe harbor. So I would ask you to go back and put that in writing.

One question for Mr. Alvarez, and I know this has come up already, on CLOs. Can you tell me where in Dodd-Frank you don't have the power to grandfather CLOs? Because a 2-year extension and a grandfathering aren't that much different except a grandfathering would allow those entire portfolios to run off in their fairly shortened duration.

So can you help me understand? Can you cite the section or the page number of Dodd-Frank that doesn't give you the authority you claim you want?

Mr. ALVAREZ. I can't cite the page number or the section but I can tell you what it says. There is a provision in the Dodd-Frank Act that says all investments and activities by banking entities must conform with the requirements of that section by the effective date, which is July 21, 2014, unless the Federal Reserve Board provides an extension.

Then the statute goes on to say the Federal Reserve may provide one extension at a time for a cumulative amount of no more than three extensions.

Mr. STIVERS. Okay. So that seems pretty clear to me how long these CLOs are. You could have made the extension an essential grandfathering by looking at the term.

These things run off in 3 to 5 years. They are relatively short-term. Why not deal with the whole thing instead of having to take two bites of the apple? It just doesn't make sense.

Mr. ALVAREZ. No, I appreciate that. And I think we would have appreciated the flexibility to be different, but the statute is quite specific. It says that we can grant three, 1-year extensions, but no more than one at a time. And we thought that—so we indicated our intention to grant those extensions. We have already granted one;

we did so just in this past December. And we will grant the next two in turn.

Mr. STIVERS. Thank you.

The only thing I would add about that is we have talked a little bit today about uncertainty. When you do multiple extensions and you do them for shorter duration, it adds to uncertainty for these businesses that finance things through CLOs, to the marketplace, and to those financial institutions which need that capital. So I would be concerned about that.

One last question for Mr. Osterman: The FDIC approved a bunch of tailored plans at the end of the year for some resolution of some of the smaller banks. Do you think that adds any risk to the system?

Mr. OSTERMAN. I am not familiar with what you are referring to—tailored plans?

Mr. STIVERS. Yes.

Mr. OSTERMAN. In connection with—

Mr. STIVERS. In resolution.

Mr. OSTERMAN. Oh, in terms of the resolution. The—

Mr. STIVERS. So you obviously don't think it adds risk, right, or you wouldn't have approved them?

Mr. OSTERMAN. The plans were not approved. We are going through a process of reviewing the resolution plans and they have not been approved. They are in the process of being reviewed and it is an—

Mr. STIVERS. I know I don't have much time left. When you allow people to submit tailored plans, clearly you understand there is not much risk there, and—

Chairman HENSARLING. In fact, the gentleman has no time left.

Mr. STIVERS. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Mr. Osterman, I don't want to sound like we are piling on here, but for some of us this Operation Choke Point information is just coming to the fore. And I was particularly struck by Mr. Luetkemeyer's opening comments, when he had the letter from the bank to the non-depository financial institution saying, "Look, you are a good customer; you are doing everything legally; you have been a great customer for a long time, but we just can't do business with you anymore."

And when you add that to the statements from a bureaucrat, no matter how low-ranking they may be, who says to a particular legal industry, "You don't have the moral right to exist," this is the type of thing that, congratulations, now you have our attention. That is not the kind of thing that goes away, and I hope you send that message back to the FDIC.

In fact, I hope that all of you take it to your various agencies. And it is not just that saying it is the problem; it is thinking it that is the problem. The fact that anybody would actually think that in this country, somebody else doesn't have the right to do something that is moral really gets our attention and it is not going to go away anytime soon.

Let me ask you, your written testimony lays out, I think, very well the purposes of the FDIC, so you have an ongoing commitment to ensure that its regulations and policies achieve legislative and regulatory goals in the most efficient and effective manner possible. Is it a legislative goal of the FDIC to restrict the legal operation of a non-depository financial institution business?

Mr. OSTERMAN. No, it is not. In fact, we wouldn't—we obviously wouldn't be legislating. That would be up to you all, but—

Mr. MULVANEY. Is it a regulatory goal of yours?

Mr. OSTERMAN. No.

Mr. MULVANEY. Okay. Is there anything inherently unsafe or unsound—you have talked today about your job, which is to make sure that financial institutions are safe and sound and operated in such a manner. Is there anything inherently unsafe or unsound about short-term lending, properly conducted, or non-depository financial lending, properly conducted?

Mr. OSTERMAN. Right. If it is properly conducted, it should be fine.

Mr. MULVANEY. Is there a value to those services to the market?

Mr. OSTERMAN. I believe there is.

Mr. MULVANEY. Would removing those services to the market make the market less safe and less sound?

Mr. OSTERMAN. Yes. If you don't have the—

Mr. MULVANEY. If Operation Choke Point has the unintended consequence of driving those legal businesses out of the market, would it be incumbent on the FDIC, in order to ensure the safeness and soundness of the markets, to prevent that from happening?

Mr. OSTERMAN. We have issued a policy statement that outlines the FDIC's position in connection with this type of activity. Again, our position is that our efforts are not targeted at legitimate businesses operating in compliance with the law.

Mr. MULVANEY. You go on to say in your written testimony, and I think, again, it is properly stated, that another critical component of our rulemaking process is to provide the public the opportunity to participate in notice and comment rulemaking, et cetera, which I happen to agree with.

Have you ever paid for a witness? Excuse me, have you ever paid for somebody to participate in the audience at one of your meetings?

Mr. OSTERMAN. No, not that I am aware of.

Mr. MULVANEY. Would it be appropriate for you to do that?

Mr. OSTERMAN. I don't know—

Mr. MULVANEY. Would it be appropriate for you to stack the audience?

Mr. OSTERMAN. —but it would depend on the particular circumstances of—

Mr. MULVANEY. That should be a fairly safe answer, right? Mr. Osterman, of all the questions I asked you today, that is probably the safest. It is safe to say that is not appropriate, right?

Mr. OSTERMAN. I think I know where you are going with this.

Mr. MULVANEY. Where am I going with this, Mr. Osterman?

Mr. OSTERMAN. I think you may want to ask my colleague the question.

Mr. MULVANEY. That is exactly where I am going with this.

What were you all thinking? Seriously, to pay somebody to come and participate in the—to plant somebody in the audience? And I know the story that maybe they were going to be on the panel or maybe they weren't. But you all admit now yourself this was wrong, right?

Ms. FUCHS. I don't know all the details of how the decisions were made, but it is not our general policy to do that.

Mr. MULVANEY. And it is not going to happen again, right?

Ms. FUCHS. I would imagine, but I—

Mr. MULVANEY. Would you change your policy, please, on when you release your press statements?

Right now, you all don't—you all do what is called "midnight embargoes." You issue something in the afternoon but you don't let people talk about it till after midnight or late at night. Would you change that policy?

Ms. FUCHS. We try to release our materials so that the press and other—

Mr. MULVANEY. The FDIC doesn't do that, do they? In fact, nobody else here does that, do they?

Yes. Okay.

I have 50 seconds left. I have a question for you, Mr. Alvarez, and it is on an entirely different topic.

Governor Tarullo was here and we asked him a Dodd-Frank question. I laid out—and I won't have time to give all the details—a specific trade, okay, under the Dodd-Frank prohibitions on proprietary trading. And I said, "Look, this is the type of trade where it seems that the SEC, the OCC, and the FDIC might all have concurrent jurisdiction."

And in response to my question, he said, "No. Whoever is the primary regulator has, by congressional delegation, the regulatory authority over them." And when I asked him if they could be overruled by another one of the folks who have jurisdiction, he said, "No. There is no real shared jurisdiction over a particular trade. There is one regulator on every single trade under Dodd-Frank."

Does that comport with your understanding of the implementation of that rule, sir?

Mr. ALVAREZ. I think he must have been referring to the fact that—

Mr. MULVANEY. I'm sorry. I said Dodd-Frank. I meant Volcker, and I apologize. But I would love to hear your answer.

Chairman HENSARLING. Quick answer, please.

Mr. MULVANEY. Does that comport with your understanding, sir, of the implementation of the Volcker Rule?

Mr. ALVAREZ. The statute provides that each legal entity is regulated by a particular regulator, and only one regulator. So to the extent—I don't—your question—if your question was about a legal entity doing a transaction, there is only one regulator for that legal entity under Dodd-Frank.

Mr. MULVANEY. And they can't be trumped by any other regulator?

Mr. ALVAREZ. Not under the Volcker Rule.

Mr. MULVANEY. Thank you, sir.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair recognizes the gentleman from Florida, Mr. Ross, for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Being from Florida, I had an opportunity when we had our payday lending issues that were pretty bad—and in fact, I was in the legislature at the time and we passed some laws that have become now the gold standard, I think, for all other States to follow with regard to payday lending.

So I am really interested in what the Federal Government is going to do when it comes to this industry, and I guess I want to ask the first question of Ms. Fuchs, Mr. Osterman, and Ms. Friend. And following up on what Mr. Mulvaney was talking about, if the regulatory control is so strong to restrict or otherwise cut off the supply, if you will, of payday loans, is it your understanding, then, that the demand would go away?

Ms. Fuchs?

Ms. FUCHS. The Bureau is looking at payday lending right now and looking at whether rules are—

Mr. ROSS. I guess what I am getting at is that we could all agree that if you can—if, through Operation Choke Point and whatever other methods have been out there, to try to prohibit the market from existing, that the demand will still exist, will it not? There will still be people who will need the use of payday loans. Banks don't want payday loans. There is a market niche for payday loans, is there not, Ms. Fuchs?

Ms. FUCHS. We understand that there is a need for small-dollar, short-term lending, and the Bureau is very conscious of that and—

Mr. ROSS. And, Mr. Osterman, you would agree, too?

Mr. OSTERMAN. Yes.

Mr. ROSS. And, Ms. Friend, you would agree, as well?

We have to live with the fact that demand will be there, and if we try to overregulate the supply, there will be a black market for it, which will make matters worse. And I think Mr. Osterman kind of alluded to that when he was answering Mr. Mulvaney's questions.

Now, having said that, Operation Choke Point talks about making sure that illegal entities are not given the banking relationships, but has there been any guidance for legal entities in that regard under Operation Choke Point?

Mr. Osterman?

Mr. OSTERMAN. Again, Operation Choke Point is a Department of Justice action going after illegal activities. What we have said at the FDIC is we are not targeting legitimate business. And all we want is to make sure our banks are running in a safe and sound manner. That is our perspective.

Mr. ROSS. I appreciate that, but I have had people come to me, bankers come to me—

Mr. OSTERMAN. Yes.

Mr. ROSS. —recently, within the last month, 2 months, who have been told that because of the—what was it, the relational, reputational risk that they should not be engaged with this particular entity. Now, this is a legal entity. Are you offering any guidance to these banking institutions as to what legal entities are okay with them to operate?

Mr. OSTERMAN. We have issued a financial institution letter, which has gone out to the industry, indicating that as long as the bankers are dealing—they do their due diligence and ensure that those entities are operating in a legal manner—

Mr. ROSS. And do you give them—

Mr. OSTERMAN. —then that is—

Mr. ROSS. —the standards of that due diligence, or is that left open to a—

Mr. OSTERMAN. That is up to them. We are not going to prescribe that.

But we also told our regional offices and field offices that as long as people were acting in a legal manner, it is not our job to—

Mr. ROSS. For those banks that have been wrongly terminated, in terms of their relationship with legal entities, have you done anything to facilitate the rebuilding of those relationships?

Mr. OSTERMAN. This is something that is just happening very recently.

Mr. ROSS. Yes.

Mr. OSTERMAN. Right. And so, we are, again, letting our examiners know what the expectations are. And I think there was an article today in The Banker indicating that the industry itself was looking at how to police itself and create some standards that could be used to ensure that they are operating in a way—

Mr. ROSS. That these legal entities are not interrupted with their banking relationships.

Ms. Friend, the OCC has been rather quiet on any guidance. Is that a pattern that I think we are to expect or do you expect there to be some guidance with regard to payday lending and Operation Choke Point, for that matter?

Ms. FRIEND. We don't have any guidance on Operation Choke Point. As has been said before, it is a Department of Justice investigation so we are not part of that.

We had issued guidance in 2008, and our examiners and banks have been following that. And that basically suggests the banks have to do due diligence when they bank different types of customers.

Mr. ROSS. And one quick question for Mr. McKenna, because I don't want to leave you out there. I know it has been a little quiet lately.

With regard to risk-based capital rules, do you have a timeframe for the implementation of those? Banks have, I think, 1 to 2 years to have it. What do you say—

Mr. MCKENNA. The comment period currently ends on May 28th, and we will be considering all the comments, and then we will decide on the implementation after that.

Mr. ROSS. Okay.

Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman. Thank you for calling this important hearing.

I would like to thank Congressman Heck, my colleague and the esteemed friend that I have who is now serving as a ranking mem-

ber, for his very kind comments regarding the CFPB Small Business Advisory Council. And I look forward to working with him on the passage of this bill, and thank him for joining with me as a sponsor of this bill.

I would like to say that as such, Ms. Fuchs, you all have been able to establish the Community Bank Advisory Council, the Credit Union Advisory Council, and the Academic Research Council, all done without legislative action. I think I am just curious to know why you would not have done this council for the small business, given the critical importance that it plays.

Ms. FUCHS. Thank you so much for your question.

As I mentioned before, we actually currently have a very, very good means of getting small-business input when our rules are going to affect small businesses. So through our small-business panels, we provide small businesses with information on proposals before we propose a rule. We meet with them—

Mr. PITTENGER. But you would agree that these—this council then—formalize this and create a better opportunity for dialogue and input from small business?

Ms. FUCHS. The Bureau doesn't take a position on legislative bills.

Mr. PITTENGER. Thank you.

Ms. FUCHS. I am happy to bring back your comments—

Mr. PITTENGER. I understand.

We moved into a new house 5 years ago and my wife wanted some bushes planted. And we planted these bushes and I got a really fine person out there to help me do it. And in about a year, those bushes died.

So we planted some more bushes. And in another year, those bushes died. And then it happened again, and I thought, "Now, something is wrong."

So I got another guy out there and he started digging. And he found a lot of red clay—impervious soil that wouldn't let the water go through.

And it made me think, all the good efforts of those folks who were planting those bushes was to no avail because those bushes would turn yellow, and they would look bad, and some would die. And they couldn't function.

And it seems to me that, although sincerely done and with good intentions, the enormous regulatory environment that we have today is killing the needed growth for our economy.

As I recall, back in the 1970s we had very high interest rates, high unemployment—it was a very difficult time. It was called the malaise of Jimmy Carter.

And following his completion of his term there was a man elected named Ronald Reagan. And Ronald Reagan came in and he cut all these enormous regulations. And what happened was, in a matter of 2 years we were creating 300,000, 400,000, 500,000 jobs a month. One month, a million jobs.

We weren't having an anemic job growth of—or economy of 2 percent. We had about 1.6 percent economic growth.

Do you think maybe with all these good intentions, we have created an impervious soil that we can't grow? And do you feel any concern that maybe, although well-intended, the impediments are

there—these rules, these regulations, these requirements, the uncertainty in the market because of not knowing what the regulators are going to do next?

It seems to me that would be first on my mind to consider that maybe what was intended for good is really meant for bad.

Do you have a comment you would like to make on that?

Sure, we will start with you, Ms. Fuchs.

Ms. FUCHS. We very much share your concerns about regulatory certainty, and that is why we have many means of speaking with industry. At the same time, we also hear from consumers. And through our consumer response function we have received over 300,000 complaints from consumers about issues that they are seeing with their consumer finance activities. And—

Mr. PITTENGER. Let me give you one example that occurred in my own town. A wonderful little bank, Bank of Commerce, about a $130 million bank, just announced last month that it had to merge with a larger bank. It could not absorb the regulatory requirements imposed on it—the same requirements of the larger institutions. And now, they have gone out of business.

In 2007, we had about, oh, I think 8,500 banks in this country, and now there are about 6,800. That is a loss of 1,700 banks that have either had to merge or they have had to be absorbed.

And I just think that there should be some serious consideration on revamping everything that we are doing on our regulatory environment.

Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus, for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Ms. Fuchs, under analysis done by the CFPB for the QM rule, pursuant to the Paperwork Reduction Act, the Bureau estimated that the compliance burden for the QM rule for one person is only 30 minutes and the estimated burden for each financial institution subject to QM is 1 hour.

Do you believe that these are reasonable estimates?

Ms. FUCHS. When the Bureau is engaged in the rulemaking, it does whatever it can to get data on the cost and the burden of the rulemaking. We try to understand what institutions do to comply with the rule. In fact, the Bureau has conducted a study about operational compliance activities that banks engage in—

Mr. ROTHFUS. So do you believe these are reasonable estimates then?

Ms. FUCHS. I believe they are reasonable.

Mr. ROTHFUS. Okay. The Paperwork Reduction Act analysis for the QM rule fails to provide an analysis for how the financial institution 1-hour estimate was calculated. Will you commit to providing this committee with a more detailed and thorough analysis?

Ms. FUCHS. When we do our Paperwork Reduction Act analysis, we do publish it in our proposal and our final rule. And so we take public comments, which is essentially the way the—

Mr. ROTHFUS. Again, there was a failure to disclose how you arrived at 1 hour for the financial institution. Will you commit to pro-

viding this committee with a more detailed and thorough analysis of that?

Ms. FUCHS. I will certainly take back your comments to our economists. We try to do our best to explain both the data we rely on and the methodology in reaching our results.

Mr. ROTHFUS. We are already seeing the first signs that some smaller community financial institutions are exiting the mortgage business rather than trying to navigate the liability risk and excessive compliance costs inflicted by the Bureau's qualified mortgage rule. Indeed, a recent American Banker headline has suggested that QM will come to stand for "quitting mortgages."

Ms. Fuchs, how do you reconcile the one-size-fits-all approach taken by the CFPB in promulgating the QM rule with your statutory obligations to promote consumer choice and facilitate access and innovation in the marketplace?

Ms. FUCHS. Thank you for your question.

The QM rule was specifically designed to consider the differences between smaller lenders and larger lenders, including lenders in rural and underserved areas.

We include within the loan specific provisions for small creditors who hold loans within their portfolio. We also have a 2-year window under which small creditors may make balloon loans that are held within portfolio.

All of these things are in direct response to comments we heard from smaller lenders about the impact of the—

Mr. ROTHFUS. Again, does it concern you, though, that entities will stop making mortgages as a result of this rule?

Ms. FUCHS. The Bureau is watching the impacts of the QM rule. And as I mentioned earlier, the rule was specifically designed so that 90 percent to 95 percent of the mortgages that were being made before the QM rule was put in place would be covered by the QM rule.

Mr. ROTHFUS. But won't the overall effect of the QM rule be to advantage certain types of products and certain terms in the marketplace over others?

Ms. FUCHS. Don't forget that after the financial crisis, the marketplace changed. And the marketplace changed because there were products that caused the very risks that led to the financial crisis.

We anticipate that over time, as the market—

Mr. ROTHFUS. So you wouldn't agree that maybe the cause was when the former chairman of this committee talked about rolling the dice with respect to the housing market?

Ms. FUCHS. No. We feel that as the market gets comfortable with the QM rule, lending will evolve. And we anticipate that there will be innovation in the non-QM space. In fact, we specifically were trying to preserve room for that innovation when we crafted the rule.

Mr. ROTHFUS. In an article that appeared—this is going to go to Mr. Osterman and Mr. Alvarez—in the pages of The Wall Street Journal, it was reported that in the third quarter of 2013, the number of federally-insured banks in the United States fell below 7,000 for the first time since Federal regulators began keeping track in 1934.

Are you concerned about this increased level of consolidation in the banking industry?

Mr. OSTERMAN. Thanks for your question. It is something that we are monitoring. It has been a cyclical process. If you look at the way the economy has been, it has been very difficult to—

Mr. ROTHFUS. Does the consolidation in the industry concern you?

Mr. OSTERMAN. Even though there has been consolidation, institutions below the $10 billion and billion dollar range have continued to be a very vital part of the economy.

So the other thing is, in terms of new institutions getting into the industry, given the fact that we have been in such a difficult financial situation, what we have had is people coming in and actually investing in existing institutions, putting capital in those institutions.

Mr. ROTHFUS. And how many institutions have been created since this law was passed?

Mr. OSTERMAN. Since Dodd-Frank?

Mr. ROTHFUS. Since Dodd-Frank was passed.

Mr. OSTERMAN. Again, the economic situation—I think we had a de novo last year that was created. It has been very low—very low amounts.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. There are no other Members in the queue.

I would like to thank the witnesses for their testimony today and for their patience in having to sit all this time.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:31 p.m., the hearing was adjourned.]

A P P E N D I X

April 8, 2014

Opening Statement of Congresswoman Carolyn B. Maloney
Full Committee Hearing on Dodd-Frank Implementation
April 8, 2014

Thank you, Mr. Chairman and Ranking Member Waters, for holding this hearing, and thank you to the witnesses for appearing here today.

Dodd-Frank was the most sweeping overhaul of our financial regulations since the Great Depression. The implementation process for such a sweeping overhaul was never going to be short — nor should it be.

People often cite the post-Depression financial reforms as a model of success, but it's important to remember that those reforms also took a very long time to implement.

While the Securities Act of 1933 was a landmark reform of our securities markets, the SEC didn't adopt the '33 Act's main anti-fraud rule — Rule 10(b)(5) — until 1948, or over 15 years after the '33 Act was passed.

It's also important to recognize that financial reform is a work in progress — and will improve and solidify with time.

When the Investment Company Act of 1940 was passed, it was called, at the time — and I quote — "the most intrusive financial legislation known to man or beast."

That same "intrusive financial legislation" gave birth, of course, to the large and thriving U.S. mutual fund industry.

In sum, financial reform — done properly — takes time. It requires flexibility on the part of regulators, Congress, and the industry.

So far, the regulators have shown great flexibility in implementing Dodd-Frank, and I urge the regulators to continue this practice as they finalize the last of the major Dodd-Frank rules.

I look forward to hearing from the witnesses, and I yield back.

For release on delivery
10:00 a.m. EDT
April 8, 2014

Statement by

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

April 8, 2014

Chairman Hensarling, Ranking Member Waters, and other members of the committee, I appreciate the opportunity to testify on recent rulemakings and other actions by the Federal Reserve. In my testimony, I will discuss some of the actions that the Federal Reserve has completed or has under way to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and other reforms to promote a stable financial system and to strengthen the resiliency of banking organizations. The Federal Reserve is committed to strengthening the safety and soundness of the financial companies it supervises so that these organizations have the ability to meet their financial obligations and continue to make a broad variety of financial products and services available to households and businesses even in times of economic difficulty.

The Federal Reserve has made significant progress in implementing the Dodd-Frank Act reforms, which were designed to improve the resiliency of financial firms and the system as a whole. At the same time, we recognize that regulatory compliance can impose a disproportionate burden on smaller institutions. Smaller institutions tend to lend in neighborhoods where the institutions' depositors live and work, helping to ensure that local communities maintain access to credit. In addition to overseeing large banking firms, the Federal Reserve supervises approximately 800 state-chartered community banks that are members of the Federal Reserve System and several thousand small bank holding companies. The Federal Reserve has strived and will continue to strive to ensure that its regulations and supervisory framework are not unnecessarily burdensome for community banking organizations so they can continue their important function of safe and sound lending to local communities.

Recent Regulatory Actions Taken to Increase the Resiliency and Safety and Soundness of the Banking Industry

Implementation of Basel III

In July 2013, the Federal Reserve, together with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), approved final rules implementing the Basel III capital framework, as well as related changes required by the Dodd-Frank Act. The new capital rules strengthen the safety and soundness of banking organizations both by improving the quality of what constitutes regulatory capital and by requiring banking organizations to hold more capital. Specifically, the minimum tier 1 capital ratio was raised from 4 to 6 percent of risk-weighted assets, and a new minimum common equity tier 1 capital ratio of 4.5 percent of risk-weighted assets was established. The rules also require a capital conservation buffer of 2.5 percent of risk-weighted assets to ensure that banking organizations build capital when they are able to do so. The rules also introduced a more risk-sensitive standardized approach for calculating risk-weighted assets.

In adopting the final capital rules, the banking agencies sought to strengthen the quality and quantity of bank capital without imposing unnecessary burden on community banks. To achieve this goal, the banking agencies in the final rule made changes to the proposal to address concerns about regulatory burden on community banks. Many of the Basel III requirements will not apply to smaller banks--including the countercyclical capital buffer, supplementary leverage ratio, trading book reforms, accumulated other comprehensive income flow through, higher capital requirements for counterparty credit risk on derivatives, and disclosure requirements. The Federal Reserve and the other banking regulators also issued a Community Bank Guide to

the new capital rules to help non-complex community banking organizations understand the applicability of the new rules to their operations.

Stress Testing and Capital Planning Requirements for Large Banking Organizations

The comprehensive stress testing conducted by the Federal Reserve, pursuant to the Dodd-Frank Act and in connection with the annual Comprehensive Capital Analysis and Review (CCAR), is one of the Federal Reserve's most important tools for ensuring the resiliency of banking firms during periods of financial or economic stress. This exercise and the accompanying rules apply to the largest banking organizations, and recognize the greater risk these firms pose to financial stability in times of stress.

Last month, the Federal Reserve published the results of its annual stress tests, which demonstrated that the largest banking institutions in the United States are collectively much better positioned to continue to lend to households and businesses and to meet their financial commitments in a severe economic downturn than they were five years ago. The stress tests this year were the fourth round led by the Federal Reserve since 2009. This year, in addition to the 18 institutions that have been part of previous stress tests, an additional 12 firms with assets greater than $50 billion were included.

The quantitative results from the scenarios in the supervisory stress tests are one component of the Federal Reserve's analysis of the capital adequacy at the largest financial institutions during the CCAR. The Federal Reserve also evaluates each institution's capital planning process, in particular the firm's ability to account for the idiosyncratic risks of the firm and the firm's ability to maintain sufficient capital to continue to operate through times of financial and economic stress given those firm-specific risks. Last month the Federal Reserve

approved the capital plans of 25 bank holding companies participating in the CCAR. The Federal Reserve objected to the plans of the remaining five participating firms--four based on qualitative concerns and one because it did not meet a minimum post-stress capital requirement. All but two of the 30 participants in this year's CCAR are expected to build capital from the second quarter of 2014 through the first quarter of 2015.

Overall, this exercise has resulted in the 18 largest banking firms increasing their tier 1 common equity by more than $500 billion since 2008. That means that the strongest form of loss absorbing capital at the largest banking firms has more than doubled since the financial crisis.

Enhanced Prudential Standards

The Federal Reserve recently finalized a rule implementing section 165 of the Dodd-Frank Act to establish enhanced prudential standards for large banking firms. This rule applies to bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more. The final rule establishes a number of enhanced prudential standards designed to increase the resiliency of the operations of large banking firms and mitigate the risk that the material financial distress or failure of these firms would pose to the financial stability of the United States. These standards include liquidity, risk management, and capital. In addition, the rule requires foreign banking organizations with U.S. non-branch assets of $50 billion or more to form a U.S. intermediate holding company and imposes enhanced risk-based and leverage capital, liquidity, risk-management, and stress-testing requirements on the U.S. intermediate holding company.

Community banking organizations are not subject to the Federal Reserve's enhanced prudential standards for larger banking firms, such as capital plans, stress testing, resolution plans, single-counterparty credit limits, and capital surcharges for systemically important financial firms.

Leverage Ratio

In July 2013, the Federal Reserve, together with the FDIC and the OCC, issued a proposed rule to strengthen the leverage ratio standards for the most systemically significant financial institutions by establishing a new leverage buffer for bank holding companies with more than $700 billion in consolidated assets or $10 trillion in assets under custody. The proposal currently would apply to the eight most systemically significant U.S. bank holding companies and their insured depository institution subsidiaries. The proposal would require these bank holding companies to maintain a tier 1 capital leverage buffer of at least 2 percent above the minimum Basel III supplementary leverage ratio of 3 percent to avoid restrictions on capital distributions and discretionary bonus payments. In addition, the insured depository institution subsidiaries of covered bank holding companies would be required to satisfy an enhanced leverage ratio of 6 percent to be considered "well capitalized" for purposes of the agencies' prompt corrective action regulations. A strong capital base is particularly important at these organizations because capital shortfalls have the potential to result in significant adverse economic consequences and contribute to systemic distress both domestically and internationally, which could impair credit availability to businesses and consumers. Higher capital standards for these organizations will place additional private capital at risk before the federal deposit insurance fund and the federal government's resolution mechanisms would be

called upon, and reduce the likelihood of economic disruptions caused by problems at these organizations.

Later today, the Board is scheduled to consider a final rule that would implement the enhanced supplementary leverage ratio for the eight most systemic U.S. banking firms. In addition, the Board is scheduled to consider an interagency proposal that would modify the definition of total leverage exposure (the denominator of the supplementary leverage ratio) in the agencies' final capital rules.

Liquidity Coverage Ratio

In October 2013, the Federal Reserve and the other U.S. banking agencies issued a proposed rule that would create a standardized minimum liquidity requirement for large and internationally active banking organizations and systemically important, non-bank financial companies designated by the Financial Stability Oversight Council (Council). These institutions would be required to hold minimum amounts of high-quality, liquid assets, such as central bank reserves and government and corporate debt, that can be converted easily and quickly into cash. Each institution would be required to hold liquidity in an amount equal to or greater than its projected new cash outflow during a short-term stress period. Liquidity standards for large U.S. banking firms will help promote lending during periods of financial or economic stress, as they work in concert with capital standards, stress testing, and other enhanced prudential standards to help ensure that banking organizations have a liquidity risk profile that is strong enough to prevent runs by bank creditors and counterparties.

The Board's proposal would apply in full only to bank holding companies and savings and loan holding companies that do not have significant insurance or commercial operations, but

that have $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposures. For bank holding companies and savings and loan holding companies not subject to the interagency proposal, the Board also proposed a modified liquidity coverage ratio standard for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have more than $50 billion in total assets. The agencies are in the process of reviewing comments on the proposal.

Resolution of Large, Interconnected Financial Firms

One of the ways in which the Dodd-Frank Act seeks to address the problems of too-big-to-fail is by reducing the potential damage to the financial system and the economy from the failure of the largest, most complex financial firms. In this regard, the Federal Reserve and the FDIC are working jointly to improve the bankruptcy resolution planning of large banking firms. In addition, the Federal Reserve is assisting the FDIC in making large banking firms more resolvable under the Orderly Liquidation Authority (OLA) of the Dodd-Frank Act.

The Dodd-Frank Act requires all bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Council for supervision by the Federal Reserve to develop, maintain, and periodically submit resolution plans to regulators that would facilitate these entities' resolution under the Bankruptcy Code. Each plan must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company. Companies subject to the resolution plan requirement filed their initial resolution plans on a staggered schedule. The first group of 11 companies, generally those bank holding companies with $250 billion or more in total nonbank assets (or total U.S. nonbank assets in the case of a foreign-based company), submitted initial

plans in July 2012 and their second annual plans in October 2013. These companies' second plans responded to guidance provided by the Federal Reserve and FDIC. The second group, generally those bank holding companies with $100 billion or more, but less than $250 billion, in total nonbank assets (or total U.S. nonbank assets in the case of a foreign-based company), submitted their initial plans in July 2013. The third group, generally all other bank holding companies with $50 billion or more in total consolidated assets, filed their initial resolution plans on December 31, 2013. The Federal Reserve and FDIC are reviewing all submissions received during 2013.

In implementing OLA, the FDIC proposed the single point of entry (SPOE) resolution approach, which is intended to concentrate losses on the shareholders and long-term unsecured debt holders of the parent holding company. Under the SPOE approach, a well-capitalized bridge holding company would be created in place of the failed parent by converting long-term debt holders of the parent into equity holders of the bridge. The new parent would recapitalize the critical operating subsidiaries of the failed firm, to the extent necessary, thereby allowing their operations to continue. Successful execution by the FDIC of its preferred SPOE approach in OLA depends on the availability of a sufficient combined amount of equity and loss-absorbing debt at the parent holding company of the failed firm. Therefore, the Federal Reserve is consulting with the FDIC on a regulatory proposal that would require the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding long-term, unsecured debt in addition to the regulatory capital those companies already are required to maintain.

Risk Retention

Section 941 of the Dodd-Frank Act requires firms generally to retain credit risk in securitization transactions they sponsor. This requires that securitizers retain some of the credit risk of the assets they securitize (sometimes referred to as "skin in the game"). Retaining credit risk creates incentives for securitizers to monitor closely the quality of the assets underlying a securitization transaction and discourages unsafe and unsound underwriting practices by originators. In August 2013, the Federal Reserve, along with a number of other agencies, revised a proposal from 2011 to implement section 941. The comment period on this re-proposal recently closed, and we are working with the other agencies charged by the Dodd-Frank Act with implementing this rule to complete this rulemaking.

Federal Reserve Rulemaking Process

The Federal Reserve for many years has believed that our regulatory efforts should be designed to minimize regulatory burden consistent with the effective implementation of our statutory responsibilities. For example, to become informed about benefits and costs of a regulatory proposal, we often collect information directly from those that we expect would be affected and conduct meetings with interested parties and their representatives prior to designing the proposal. We also specifically seek comment on the costs and benefits of our proposed approach as well as invite comment on alternative approaches. We provide the public a minimum of 60 days to comment on all significant rulemaking proposals, with longer periods permitted for especially complex or significant proposals, such as our capital rules. In issuing a final rule, we seek to adopt the approach that faithfully reflects the underlying statutory provisions while minimizing regulatory burden.

All of the rules described earlier have been issued or proposed in accordance with the Administrative Procedure Act (APA). A rule issued under the APA creates legally enforceable duties and is binding on the issuing agency, courts, and the private parties it affects. Agencies, including the Federal Reserve, also frequently issue guidance to supervised entities. Unlike an agency rule, guidance is not legally enforceable. Instead, guidance interprets or clarifies the nature of duties created by a statute or a rule. While we are not required to do so under the APA, the Federal Reserve typically invites the public to comment on significant statements of supervisory guidance. For example, we invited public comment on guidance regarding supervisory expectations for stress tests conducted by financial companies with total consolidated assets between $10 billion and $50 billion, supervisory guidance to help ensure that financial institutions provide leveraged financing to creditworthy borrowers only in a safe and sound manner, and guidance related to income tax allocation agreements involving holding companies and insured depository institutions. In addition, we make available to the public our examination manuals, transaction approvals and denials, and other matters of interest to the public related to our regulatory responsibilities.

In the process of adopting a rule, we conduct an assessment that takes appropriate account of the potential impact a rule may have on small businesses, small governmental jurisdictions, and small organizations affected by the rule, in accordance with the Regulatory Flexibility Act. We pay particular attention to reducing the regulatory burden on community banking organizations whenever possible and rely on our ongoing dialogue with such institutions when considering rules. For example, the Federal Reserve has established Community Depository Institution Advisory Councils at each of the 12 Federal Reserve banks. These

councils regularly collect input from community depository organizations on a number of topics, including ways to reduce regulatory burden and to improve the efficiency of our supervision. A representative from each of these 12 advisory councils serves on a national council that meets semiannually with the Federal Reserve Board in Washington, D.C.

The Federal Reserve also has established a community bank subcommittee of our Committee on Bank Supervision that oversees the supervision of community banks and reviews regulatory proposals to help ensure they are appropriately tailored for community banks.

Conclusion

The Federal Reserve has made significant progress in implementing the Dodd-Frank Act and other measures designed to improve the resiliency of banking organizations and the financial system. The Federal Reserve will continue to work with other U.S. financial regulatory agencies and the institutions we supervise to ensure that these institutions operate in a safe and sound manner and are able to provide credit even during economic downturns. We are committed to promoting a stable financial system in a manner that does not impose a disproportionate burden on smaller institutions. To help us achieve this goal, we will continue to seek the views of these organizations and the public as we further develop regulatory and supervisory programs to strengthen the ability of banking organizations to lend to households and businesses. Thank you for inviting me to present the Federal Reserve's views on these important matters. I look forward to answering any questions you may have.

TESTIMONY OF

AMY S. FRIEND

SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL

OFFICE OF THE COMPTROLLER OF THE CURRENCY

before the

HOUSE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

April 8, 2014

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to appear before you today. The Office of the Comptroller of the Currency (OCC) supervises more than 1,700 national banks and federal savings associations (collectively, banks), constituting approximately 25 percent of all federally insured banks. These institutions range from community banks to the nation's largest and most complex financial institutions and, together, they hold more than 69 percent of all commercial bank assets. The banks we supervise have made significant strides since the financial crisis in repairing their balance sheets through stronger capital, improved liquidity, and timely recognition and resolution of problem loans. While these are positive developments, we continue to stress that institutions remain vigilant about identifying and monitoring risk.

My testimony today discusses the OCC's rulemaking, supervisory, and enforcement processes and recent actions, as well as the economic analyses we conduct with respect to our rulemakings, and our approach to banking products and services. Before turning to these matters, however, I would like to take this opportunity to review briefly the OCC's efforts to address the unique set of challenges community banks face in the current financial environment. This is a time of significant change for institutions of all sizes as they grapple with an evolving regulatory landscape and difficult business environment. Although regulations implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) have focused generally on larger institutions, certain provisions of the Act affect the entire banking sector. These changes can strain the more limited resources of community banks. As I will discuss next, the OCC is committed to addressing these concerns wherever possible. We have instituted a number of initiatives to do so and will continue to reevaluate and look for additional ways to minimize burden on community banks.

I. OCC Commitment to Community Banks

The OCC supervises over 1,350 community banks with assets under $1 billion, of which 893 have less than $250 million in assets. These institutions continue to make positive strides post-financial crisis. The number of troubled institutions has declined significantly since peaking in 2010, capital is increasing, and we have recently seen an uptick in lending. Community banks provide small businesses and communities across the nation with the essential financial services and credit that are critical to economic growth and job creation.

Given the broad array of institutions we oversee, the OCC understands a one-size-fits-all-approach to supervision does not work, especially for community banks. We recognize that community banks have different business models and more limited resources than larger banks, and, to the extent underlying statutory requirements allow it, we factor these differences into the rules we write and the guidance we issue.

The OCC seeks to minimize burden on smaller institutions through various means. Explaining and organizing our rulemakings so these institutions can better understand the scope and application of our rules, providing alternatives to satisfy prescriptive requirements, and using exemptions or transition periods, are examples of ways in which we tailor our regulations to accommodate community banks while remaining faithful to statutory requirements and legislative intent.

For example, our final interagency rule to implement the domestic capital requirements illustrates how we seek to tailor our regulatory requirements to reflect the activities of individual banks. In response to community bank concerns, our final rules retained the current capital treatment for residential mortgage exposures and allowed community banks to elect to treat certain accumulated other comprehensive income (AOCI) components consistently with the

current general risk-based capital rules. Treating AOCI in this manner helps smaller institutions avoid introducing substantial volatility into their regulatory capital calculations.

In June 2013, the OCC responded to community bank concerns when finalizing our revised lending limits rule in accordance with section 610 of the Dodd-Frank Act to include counterparty credit exposures arising from derivatives and securities financing transactions. Specifically, the rule now exempts from the lending limits calculations certain securities financing transactions most commonly used by community banks. In addition, the rule permits smaller institutions to adopt compliance alternatives commensurate with their size and risk profile by providing flexible options for measuring counterparty credit exposures covered by section 610, including an easy-to-use lookup table.

Our final rule implementing the Volcker Rule provisions of the Dodd-Frank Act is another example of how we seek to adjust regulatory requirements, where consistent with the underlying statute, to reflect the nature of activities at institutions of different sizes. The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities covered by the prohibitions in the statute. One of the OCC's priorities in the interagency Volcker rulemaking was to make sure that the final regulations imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments.

The final regulations accomplish this priority and impose compliance obligations accordingly. First, banks that do not engage in covered activities or investments are not required to establish a compliance program under the final regulations. Second, the final regulations made adjustments to the proposed compliance program requirements so as to minimize burdens on banking entities with total consolidated assets of $10 billion or less that are engaged in a more

limited amount of covered activities. These banking entities are only required to update their existing policies and procedures to include references to the requirements in the final regulations, as may be appropriate given their activities and complexity. Thus, a community bank that trades only in "plain vanilla" government obligations has no compliance obligations under the regulations, and community banks that engage in other low-risk covered activities will be subject only to minimal requirements.[1]

The OCC also is providing more manageable ways for community banks to digest large amounts of information and to assist them in quickly and easily understanding whether and how this information applies to them. For example, in each bulletin transmitting a new regulation or supervisory guidance to our banks, we now include a box that allows community banks to assess quickly whether the issuance applies to them and, if so, clearly identifies the impact of the issuance. We have also identified other means to convey plain language descriptions of complex requirements, such as the two-page summary the OCC provided in connection with the final domestic capital rule highlighting aspects of the rule applicable to community banks. Likewise, we provided to community banks a quick reference guide to the mortgage rules the Consumer Financial Protection Bureau issued in January.

II. OCC Rulemaking and Economic Analyses

Agency issuances may take many forms and, accordingly, the OCC has a full range of options to communicate standards and expectations to the entities we supervise. The OCC uses informal, notice-and-comment rulemaking to establish binding norms; for example, when

[1] Shortly after the agencies issued the final rule, we began to hear concerns that certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs), which were originally issued as a means to facilitate capital-raising efforts of small banks and mutual holding companies, would be subject to eventual divestiture and immediate write-downs under the applicable accounting treatment and that the rule was inconsistent with another provision of the Dodd-Frank Act — the Collins Amendment. Given the importance of this issue to affected community banks and to mitigate the unintended consequences, the agencies responded promptly by adopting an interim final rule to address this concern. See 79 Fed. Reg. 5223 (Jan. 31, 2014), available at http://el.occ/news-issuances/federal-register/79fr5223.pdf.

Congress directs us to write a regulation or when standards lend themselves to bright-line requirements. The OCC uses informal guidance, such as policy statements and "Frequently Asked Questions" – an approach well recognized in administrative law[2] – when it is appropriate for standards to be flexible and able to be tailored to individual institutions.

The OCC takes seriously the effect of its issuances on the public and private sectors and the economy, and we conduct economic analyses of proposed and final rules. For rules that will have a major or economically significant impact, we prepare a qualitative and quantitative assessment of the costs and benefits, as well as a comparison to a baseline and one or more plausible alternatives, in a manner that is generally consistent with the Office of Management and Budget's (OMB) guidance including Circular A-4. To the extent that we can make accurate estimates, this analysis includes monetized costs and benefits. However, as OMB notes in its guidance, it is not always possible to express all important costs and benefits in monetary units. In all cases, we review a variety of sources to develop these estimates, including public information, supervisory data, academic literature, and information we obtain through the rulemaking notice and comment process.

Specifically, the OCC has adopted internal rulemaking procedures that call for us to undertake an analysis under the Unfunded Mandates Reform Act[3] that assesses whether a proposed or final rule includes a "Federal mandate" that may result in the expenditure by state, local, or tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year (adjusted for inflation). If this threshold is met, the OCC prepares a more detailed economic assessment of the rule's anticipated costs and benefits.

[2] 5 U.S.C. 553(b).
[3] 2 U.S.C. 1531 *et seq.*

Under the Congressional Review Act,[4] before any final rule can take effect, the OCC must inform both chambers of Congress whether the rule is "major." A major rule is one that the OMB determines will, or is likely to, result in a $100 million or more annual economic effect, among other things. Although OMB makes this determination, the OCC typically provides OMB with its assessment at the time it transmits a rule to OMB.

Under the Regulatory Flexibility Act,[5] the OCC determines if a proposed or final rule is likely to have a "significant economic impact on a substantial number of small entities." Under the Paperwork Reduction Act,[6] the OCC assesses the anticipated cost of any paperwork associated with its regulatory provisions.

In addition to these provisions that we follow on an ongoing basis, the OCC and the other federal banking agencies are currently engaged in a review of the burden imposed on insured depository institutions by existing regulations pursuant to the decennial review required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). EGRPRA requires that, at least once every ten years, the Federal Financial Institutions Examination Council (FFIEC), OCC, FDIC, and Federal Reserve review their regulations to identify outdated or otherwise unnecessary regulations applicable to insured depository institutions. The EGRPRA review provides the FFIEC, the agencies, and the public with an important opportunity to consider how to reduce burden on community banks through targeted regulatory changes.

I currently serve as chair of the Legal Advisory Group of the FFIEC and, in this capacity, I have been tasked with coordinating this joint regulatory review. We expect to publish the first EGRPRA notice in the very near future, and we will specifically ask the public to consider regulatory burden on community banks.

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[4] 5 U.S.C. 801 *et seq.*
[5] 5 U.S.C. 601 *et seq.*
[6] 44 U.S.C. 3501 *et seq.*

A. Informal Rulemakings

The vast majority of the OCC's rules are required by statute and are issued in accordance with the notice and comment procedures of the Administrative Procedure Act. While many of the recent OCC rulemakings are required by the Dodd-Frank Act, others are based on different statutory authority. A status update of these rules is set forth in the attached appendix.

B. Other Rulemaking Authority

In certain circumstances, such as where we wish to afford the banks we supervise more flexibility to comply with requirements or provide options for examiners to apply those requirements, the OCC has used other regulatory tools. Section 39 of the Federal Deposit Insurance Act, which authorizes the OCC to prescribe enforceable safety and soundness standards in the form of regulations or guidelines, is one such tool. Section 39 prescribes different consequences depending on whether the standards it authorizes are issued by regulation or guideline. Pursuant to section 39, if a bank fails to meet a standard prescribed by regulation, the OCC must require it to submit a plan specifying the steps it will take to comply with the standard. If a bank fails to meet a standard prescribed by guideline, the OCC has the discretion to decide whether to require the submission of such a plan. The OCC has issued three sets of guidelines using this authority. An example of a recent proposal using this authority is described below.

Heightened Expectations

The financial crisis highlighted the importance of comprehensive and effective risk management and the need for an engaged board of directors that exercises independent judgment. In 2010, we began communicating to our largest banks our heightened expectations with regard to these areas through discussions at board meetings and in written correspondence.

We continued to refine and reinforce these expectations through ongoing supervisory activities and frequent communication with bank management and boards of directors.

The OCC recently issued a proposal that would provide additional supervisory tools to examiners aimed at strengthening risk management practices and governance of large banks. This proposal builds upon and formalizes the heightened expectations program in the form of enforceable guidelines that would generally apply to insured national banks, insured federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of $50 billion or more.

The proposed guidelines set forth minimum standards for a risk governance framework. The institution's framework should address all risks to earnings, capital and liquidity, and reputation that arise from the institution's activities. The proposal also sets out roles and responsibilities for the organizational units that are fundamental to the design and implementation of the framework. The proposed guidelines contain standards for boards of directors regarding oversight of the design and implementation of a bank's risk governance framework and approval of a risk appetite statement. It is vitally important that directors understand the risks taken by their institutions and ensure there is effective, on-going risk management in place.

Issuing these heightened standards as guidelines rather than as a regulation provides the OCC with the flexibility to pursue the course of action that is most appropriate given the specific circumstances of a bank's noncompliance with one or more standards, and the bank's self-corrective and remedial responses.

III. OCC Supervision and Enforcement

The OCC is charged by statute with "assuring the safety and soundness of, and compliance with laws and regulations, fair access to financial services, and fair treatment of customers by, the institutions and other persons subject to its jurisdiction."[7] The OCC uses its supervisory and enforcement authorities to fulfill this mission. The OCC's powers include the authority to require banks to take specific actions to address and correct violations of law and unsafe or unsound practices and to provide restitution to aggrieved consumers.

The OCC's enforcement process is a direct extension of our supervision and is used where circumstances warrant. The OCC addresses violations of laws and regulations, as well as unsafe or unsound practices at banks, through the use of supervisory actions and civil enforcement powers and tools. Our policy[8] is to address problems or weaknesses before they develop into more serious issues that adversely affect the bank's financial condition, its customers and depositors, and the deposit insurance fund. Once problems or weaknesses are identified and communicated to the bank, the bank's management and board of directors are expected to correct them promptly.

Banks are subject to comprehensive, ongoing supervision that enables examiners to identify problems early and obtain corrective action quickly. Because of our regular program of examination, and at the largest institutions, our continuous, on-site presence, we often can stop and remediate unsafe or unsound practices or violations of law without having to take a formal enforcement action. This approach permits most problems to be resolved through the regular OCC supervisory process.

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[7] 12 U.S.C. 1.

[8] The OCC's Enforcement Action Policy, which was publicly released as OCC Bulletin 2011-37, provides for consistent and equitable enforcement standards for national banks and federal savings associations and describes the OCC's procedures for taking appropriate administrative enforcement actions in response to violations of laws, rules, regulations, final agency orders, and unsafe or unsound practices or conditions.

When the bank does not take appropriate corrective action in response to our supervisory process, or when problems are significant or egregious, the OCC uses its statutory enforcement authority to require corrective measures. Such actions are designed to restore the lawful operations of the bank, protect its financial stability, and serve the interests of its customers.

The OCC's enforcement actions are calibrated to reflect the seriousness of the action taken by the bank. For example, a civil money penalty is designed, in part, to deter future violations or to encourage the affected party to correct the violation or unsafe or unsound practice. In other cases, an enforcement order may require the bank to pay restitution to consumers or to cease and desist from engaging in certain activities that may be harmful to consumers or that are unsafe or unsound.

A review of the OCC's recent enforcement actions is illustrative. In the wake of the financial crisis, the vast majority of our enforcement actions were remedial, requiring banks to address and correct unsafe and unsound practices. Such actions typically included provisions tailored to the individual condition of the bank, *e.g.*, articles requiring an increase in capital, the development of a realistic strategic plan, ensuring competent management, providing for appropriate problem asset administration, and maintaining accurate books and records. The goal of such actions is to stabilize the bank, arrest its decline, and promote its timely rehabilitation. At this point, the OCC is seeing increasing numbers of banks that have stabilized or have been rehabilitated and, while some banks have failed following the financial crisis, in a significant number of such cases the OCC's enforcement actions helped limit the losses to the deposit insurance fund.

In response to serious Bank Secrecy Act (BSA) violations, the OCC has taken a number of actions to ensure that the banks have an effective BSA compliance program. The goal of such

actions is to prevent the bank from becoming a vehicle to launder the proceeds of the drug trade, terrorist financing, or other illicit activities. Such actions have required banks to adopt or enhance internal controls to assure ongoing compliance with statutory and regulatory requirements, designate a qualified officer to oversee compliance with the requirements, provide training to appropriate bank staff, and provide for independent testing of a bank's compliance with the requirements. In some instances, the actions have required review of transactions to ensure the bank has identified suspicious transactions and reported them to law enforcement by filing Suspicious Activity Reports (SARs). Following these look-backs, OCC enforcement actions have required banks to file SARs or, in some cases, amend or correct existing SARs and make other filings as required for any previously unreported activity that falls within the regulatory requirements.

The OCC has also taken a number of enforcement actions to assure fair treatment of bank customers. For example, the OCC issued an enforcement action against a bank to address unsafe and unsound practices discovered in the bank's non-home loan debt collection litigation practices and the bank's non-home loan compliance with the Servicemembers Civil Relief Act (SCRA). The order required both remediation to affected consumers and correction of deficiencies in the bank's practices and procedures in its debt collection and SCRA compliance programs. The OCC has also recently issued orders to banks to address unfair billing and deceptive marketing practices that violated section 5 of the Federal Trade Commission Act. The orders require each of the banks to take corrective measures and make restitution to consumers adversely affected by the bank's acts and practices. Finally, the orders call for the banks to pay a civil money penalty that reflects a number of factors, including the scope and duration of the violation and the financial harm to the consumers from the unfair and deceptive practices.

IV. The OCC's Approach to Bank Products and Services

The OCC generally does not determine the specific types or terms of products or services that a bank may offer its customers. We do expect banks to evaluate carefully the risks that such products or services may pose to banks and their customers. We also expect that, in offering those products and services, banks will comply with all applicable laws and regulations. Historically, when we have determined that a product's terms or structure may present substantial safety and soundness or consumer protection concerns, our approach has been to alert banks to those concerns and outline steps they should take to address them.

For example, in 2010, the OCC issued its Policy Statement on Tax Refund-Related Products,[9] which described the legal compliance, consumer protection, reputation, and safety and soundness risks associated with offering products such as tax refund anticipation loans. This guidance clearly sets forth the OCC's expectations for the measures banks should take to address these supervisory risks. In particular, the OCC was concerned about banks' ability to manage third-party risk across thousands of storefront operations. After we issued this guidance, some banks chose to no longer offer tax refund anticipation loans.

Last year, the OCC identified similar risks in deposit advance products (DAPs) offered by our supervised institutions. DAPs are small-dollar, short-term loans or lines of credit repaid from the customer's next direct deposit. DAPs pose several risks to consumers and to the institutions that offer them. They can trap consumers in a downward cycle of debt through repeated and continuous use of the product. And, they are offered to consumers without regard to the consumers' ability to repay and often with very high fees and short lump-sum repayment terms that disadvantage consumers. Further, as is often the case with these products, a bank's failure to consider the inflows and outflows in a borrower's account ignores basic tenets of sound

[9] OCC Bulletin 2010-7 (February 18, 2010).

underwriting. Banks offering these products are subject to heightened reputation, operational, and litigation risk.

To address these supervisory risks, in November of last year the OCC published "Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products" in the *Federal Register*. This guidance addresses the elevated credit, compliance, reputation, and operational risks associated with DAPs. It also provides that a bank's underwriting and credit policies should ensure that the consumer can repay a DAP, including fees, according to its terms, while still being able to pay for typical recurring expenses for food, housing, transportation, health care, and other outstanding debts. Among other factors, a bank should reevaluate the customer's eligibility and financial capacity for a DAP at least every six months. The guidance also states that banks should maintain appropriate policies and procedures designed to prevent churning and prolonged use of these products.

While the guidance is intended to outline the supervisory risks associated with these products, the OCC continues to recognize that consumers need access to responsible small-dollar credit products. Therefore, our guidance expressly encourages banks to offer small-dollar loans with reasonable repayment terms at a reasonable cost.

Today, we are aware of several banks that offer reasonably priced small-dollar loans with reasonable terms to their customers. They are designed to meet the needs of people who have little or no credit history or blemished credit records by providing them with access to credit that can be repaid within a reasonable term, rather than merely providing access to quick cash that must be repaid within a couple of weeks. Positive repayment performance on such small-dollar loans can be useful in assisting consumers with building or reestablishing good credit ratings. Good credit ratings are vital to creating long-term access to more mainstream credit

opportunities for these consumers. Banks can also play a role in helping consumers improve their financial management skills by connecting consumers that have limited or blemished credit with effective financial counseling and by encouraging them to save.

Banks have sought our guidance about offering these types of products. We have encouraged them to be innovative when designing small-dollar loan products and have shared with them our thoughts regarding our supervisory expectations with respect to various proposals. Based on our experience, we have seen that properly structured small-dollar loans can offer borrowers a safe and affordable path to economic growth, as opposed to irresponsible, high-cost loans that frequently doom these individuals to an ongoing cycle of debt.

Conclusion

Although the institutions we supervise continue to face challenges, the state of the national bank and federal thrift system is strong. The OCC will continue to look for opportunities to minimize burden, wherever possible. Thank you for the opportunity to appear before you.

Appendix
Status Update on Recent, Key Rulemakings

The following provides an update on recent OCC rulemakings required by the Dodd-Frank Act, as well as others based on different statutory authority.

Swaps Margin. Sections 731 and 763 of the Dodd-Frank Act require the federal banking agencies, together with the Federal Housing Finance Agency (FHFA) and the Farm Credit Administration, to impose minimum margin requirements on non-cleared swaps and security-based swaps for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. These agencies published a proposal to implement these requirements in 2011.

After issuing the U.S. proposal, the federal banking agencies participated in efforts by the Basel Committee on Banking Supervision (Basel Committee) and International Organization of Securities Commissions (IOSCO) to address coordinated implementation of margin requirements across the G-20 nations. Following extensive public comment, the Basel Committee and IOSCO finalized an international framework in September 2013. The agencies reviewed this framework and the more than 100 comments received on the proposal, and they are currently evaluating the changes indicated under the framework and suggested by commenters. A re-proposal is expected in the coming months.

Section 716 Push-Out. Banks that are registered swap dealers are subject to the derivatives push-out requirements in section 716 of the Dodd-Frank Act. This provision, which became effective on July 16, 2013, generally prohibits federal assistance to swap dealers. The statute required the OCC to grant institutions that it supervises a transition period of up to 24 months to comply. We have granted a 24-month transition period to nine national banks and

four federal branches, having concluded that the transition period is necessary to allow these entities to develop a transition plan for an orderly cessation or divestiture of certain swap activities that does not unduly disrupt lending activities and other functions that the statute required us to consider.

Appraisals. The Dodd-Frank Act contains a number of provisions relating to appraisals, and the federal banking agencies, together with the National Credit Union Administration, FHFA, and the CFPB, continue to work to implement these provisions. Specifically, the agencies issued a final rule last year requiring all creditors, subject to certain exceptions, to comply with additional appraisal requirements before advancing credit for higher-risk mortgage loans.

In addition, this past December, the agencies issued a supplemental rule to revise an exemption for manufactured housing and to add two additional exemptions for streamlined refinancing for certain higher-priced mortgage loans and for loans of $25,000 or less. Recently, the agencies adopted a proposal to implement the minimum requirements in the Dodd-Frank Act for state registration and supervision of appraisal management companies, known as AMCs, which serve as intermediaries between appraisers and lenders. This rule will ensure that appraisals coordinated by AMCs adhere to applicable quality control standards and will facilitate state oversight of AMCs. The proposal also will implement the Dodd-Frank Act requirement that the states report to the FFIEC's Appraisal Subcommittee information needed to administer a national AMC registry.

The agencies also are working collaboratively on a proposal to implement specific quality control standards for automated valuation models, which are computer models used to assess the value of real estate that serves as collateral for loans or pools of loans. Finally, the agencies are

considering rulemaking options to complement an interim final rule issued by the Federal Reserve in 2010, which implements statutory appraisal independence requirements.

Credit Risk Retention. The federal banking agencies, together with FHFA, the Securities and Exchange Commission, and the Department of Housing and Urban Development, continue to work on implementing the credit risk retention requirements for asset securitization in section 941 of the Dodd-Frank Act. In 2011, these agencies proposed a rule to implement section 941 and received over 10,000 comments, which offered many thoughtful suggestions. The agencies concluded that the rulemaking would benefit from a second round of public review and comment, and re-proposed the rule in September 2013. Although the re-proposal includes significant changes from the original proposal, its focus is the same — to ensure that sponsors are held accountable for the performance of the assets they securitize.

The comment period for the re-proposal has now closed, and we are working on a final rule. While we expect to complete this project in the near future, the interagency group is working through some significant issues. For example, the agencies received a substantial number of comments regarding the definition of "qualified residential mortgage" and the extent to which it should incorporate the CFPB's definition of "qualified mortgage." The agencies also received numerous comments, including some from members of Congress, regarding the treatment of collateralized loan obligations. We are carefully considering these and other issues, with the goal of balancing meaningful risk retention with the availability of credit to individuals and businesses.

Capital and Liquidity

i. *Capital.* Last year, the OCC, FDIC, and Federal Reserve finalized a rule that comprehensively revises U.S. capital standards. This rule strengthens the definition of

regulatory capital, increases risk-based capital requirements, and amends the methodologies for determining risk-weighted assets. It also adds a new, stricter leverage ratio requirement for large, internationally active banks. These revisions reflect enhancements to the international capital framework published by the Basel Committee and are a result of lessons learned from the financial crisis. The standards are designed to reduce systemic risk and improve the safe and sound operation of the banks we regulate.

Leverage Ratio Capital Requirements

Among the more important revisions to the domestic capital rules was the addition of stricter leverage ratio requirements applicable to the largest, internationally active banks. Regulatory capital standards in the United States have long included both risk-based capital and leverage requirements which work together, each offsetting the other's potential weaknesses while minimizing incentives for regulatory capital arbitrage. Unlike the risk-based capital requirements, which assign different weights to different exposures according to their relative risk, the leverage ratio is designed to be a relatively simple assessment of capital adequacy that measures a banking organization's total exposures relative to its tier 1 capital.

Our recent revisions to the capital rules now require certain large banking organizations also to meet a supplementary leverage ratio requirement. Unlike the more broadly applicable leverage ratio, this supplementary leverage ratio incorporates off-balance sheet exposures into the measure of leverage. It is expected to be more demanding because large banking organizations often have significant off-balance sheet exposures that arise from different types of lending commitments, derivatives, and other activities.

To further strengthen the resilience of the banking sector, the Comptroller is expected to sign, and the FDIC Board is expected to approve today, a final rule, which would increase

substantially the supplementary leverage ratio requirement for the largest and most systemically important banking organizations. Under this final rule, these banking organizations would be required to maintain even more tier 1 capital for every dollar of exposure, in order to be deemed "well capitalized."

Additionally, the Comptroller is expected to sign, and the FDIC Board is expected to approve today, a notice of proposed rulemaking, which would revise the calculation of the supplementary leverage ratio. This notice of proposed rulemaking is based, in large part, on revisions to the international leverage ratio standards published by the Basel Committee in January.

ii. Enhanced Liquidity Standards. Standards aimed at ensuring adequate liquidity for the banks we regulate are an important post-financial crisis tool that is central to the proper functioning of financial markets and the banking sector in general. Working together, the federal banking agencies have made significant progress in implementing the Basel Committee's Liquidity Coverage Ratio in the United States. In November of last year, the federal banking agencies issued a proposal that would require certain large financial companies, including large national banks and federal savings associations, to hold high-quality liquid assets on each business day in an amount equal to or greater than its projected cash outflows minus its projected inflows over a 30-day period of significant stress.

The comment period for the proposed rule ended on January 31, 2014. The agencies are reviewing the comments and are in the process of developing a final rule. This interagency rule, once fully implemented, will complement existing liquidity risk guidance and enhanced liquidity standards recently issued by the Federal Reserve.

Testimony of Meredith Fuchs
General Counsel, Consumer Financial Protection Bureau
Before the House Committee on Financial Services
April 8, 2014

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the invitation to appear today on the impact of regulation on financial markets and institutions. My name is Meredith Fuchs and it is my privilege to serve as General Counsel at the Consumer Financial Protection Bureau (Bureau).

As you know, the Bureau was created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), in response to the recent financial crisis. That crisis resulted in part from failures of the federal regulatory system, including the fragmented responsibility for consumer financial protection. Different regulators were responsible for overseeing different kinds of entities—even though those entities operated in the same markets—and some entities operated without any meaningful federal oversight at all. In the end, this fragmented regulatory system proved unable to protect the market for consumer financial products and services, and both consumers and the economy as a whole suffered as a result.

To address this problem, Congress created the Consumer Financial Protection Bureau. We are now hard at work fulfilling the objectives that Congress set out for us, including making sure that consumers have better information for making financial decisions, reducing unwarranted regulatory burden, leveling the playing field for different kinds of entities offering the same kinds of products and services, promoting transparent and efficient markets that facilitate access and innovation, and preventing discriminatory practices.

<u>The Consumer Financial Protection Bureau's Work</u>

In our regulatory work, we are focused on making consumer financial markets work better. More specifically, we are working to make the rules for these markets more effective, to apply them fairly and consistently, and to strengthen consumers' ability to make the decisions that are best for them. Our vision is a market where consumers can see prices and risks and compare products, and where firms do not feel pressure to lower their standards to compete.

To help achieve this vision, we have, as the Dodd-Frank Act requires, issued regulations to strengthen mortgage markets, to make federal mortgage disclosures easier for consumers to understand and less burdensome for firms to make, and to establish standards for mortgage servicing. We also have issued rules to allow us to examine a range of larger non-bank participants in the consumer debt collection, consumer reporting, and student loan servicing markets, and issued a proposed rule to enable us to examine larger participants in the international money transfer market. We are also considering regulations on debt collection, payday lending, prepaid cards, and overdraft programs.

As we do this work, we are committed to ensuring that our rules are effective at protecting consumers and making consumer financial markets work better, and that they do not unduly

burden the institutions participating in those markets. We employ a number of strategies to achieve those goals.

Consider input from a wide variety of stakeholders

First, in crafting our regulations, we consider the input of many stakeholders, including the businesses operating in the relevant markets. For example, we have created an Office of Financial Institutions and Business Liaison, which connects the Bureau with bank and nonbank trade associations, financial institutions, and businesses to enhance collaboration and communication with those groups as the Bureau does its work. We have also hosted roundtables, town halls, and field hearings across the country to get public input on topics including payday lending, debt collection, and credit reporting. At these events, we have heard from consumers, community leaders, and members of the financial services industry.

We also seek targeted input on specific regulations. In our project to reform mortgage disclosures, for example, we engaged extensively with lenders about how to reduce compliance burdens. That engagement began well before we proposed a regulation. In addition, the Bureau is the only banking regulator, and one of only three federal agencies, that the Small Business Regulatory Enforcement Fairness Act (SBREFA) requires to convene small business review panels. Pursuant to that Act, before we propose a rule that would have a significant economic impact on a substantial number of small entities, we seek input directly from small entities on the potential costs and potentially less-burdensome alternatives. To do this, we work with the Small Business Administration (SBA) and the Office of Management and Budget (OMB) to convene small business review panels to get in-depth input from 15-20 representatives of diverse small entities. Before those panels meet, we distribute materials giving a background and overview of the proposed rule or options under consideration and a detailed list of questions and issues for discussion by the small business representatives. We also make these materials public on our website and invite other stakeholders to provide feedback. The Bureau, SBA, and OMB then issue a public report that summarizes the feedback received from the small entity representatives and makes findings and recommendations. This process has proven extremely valuable. To take just one example, at the panel outreach meeting on our proposal to integrate mortgage disclosures required under TILA and sections 4 and 5 of RESPA, small entity representatives expressed concern about the proposal to require disclosures to be completed three days before closing. In response to this concern, we proposed a rule that would permit certain specific changes after the disclosure has been provided, and also solicited comment on whether additional exceptions would be appropriate.

Avoid imposing unwarranted new regulatory burdens

A second strategy we use to ensure the most effective regulation possible is to consider consciously the costs and benefits of rules to avoid imposing unwarranted new regulatory burdens. One way we do that is through the small business review panels previously described. In addition, pursuant to the Dodd-Frank Act, when issuing a rule under Federal consumer financial law, we are required to consider the potential benefits and costs to consumers and to financial service providers. This includes specifically considering the impact of the rules on banks and credit unions with assets of $10 billion or less, and on consumers in rural areas.

Similarly, under the Regulatory Flexibility Act, we generally conduct a regulatory flexibility analysis unless we determine that a proposed regulation would not have a significant economic impact on a substantial number of small entities. Those analyses consider the compliance burdens of a proposal as compared to less burdensome alternatives. Moreover, where a proposed rule would impose disclosure, recordkeeping, or information-collection requirements, the Bureau also specifically considers the burden imposed by those requirements, and ways to minimize that burden, pursuant to the Paperwork Reduction Act.

The Bureau's organizational structure was carefully designed to assure that the Bureau's rules are pragmatic and cost-effective. The Office of Regulations is housed within the Division of Research, Markets, and Regulations precisely to assure that our regulations reflect the input and insights of economists and market specialists as well as of regulatory attorneys.

Reduce existing regulatory burdens

Third, we also act deliberately to reduce existing regulatory burdens where feasible. For example, shortly after it assumed its full powers, the Bureau issued a notice seeking input on ways to streamline the regulations that the agency inherited from seven different federal agencies, so that those regulations would work better for consumers and the institutions that serve them. The comments we received have helped us to identify several priority areas for taking action to update, modify, or eliminate outdated, unduly burdensome, or unnecessary regulations, or to make compliance easier. For example, some commenters suggested that we eliminate a requirement to provide annual privacy notices in certain circumstances, such as when financial institutions do not share consumers' information with third parties or have not changed their practices since they provided the last annual notice. In response to these concerns, the Bureau is working on a proposal that, if adopted, would reduce the compliance burden for industry and unwanted paperwork for consumers. As another example, we heard about a problem with the rules that implemented a statutory requirement that credit card issuers evaluate a consumer's ability to pay before opening a new credit card account. Under the old rules, a card issuer generally could consider only the independent income or assets of the individual card applicant. This unduly limited the ability of stay-at-home spouses and partners to obtain credit cards based on the income of their spouse or partner. Last May, the Bureau published a final rule to address this problem.

In another effort to reduce regulatory burdens where practicable, we have revamped federal mortgage disclosures. For several decades, federal law generally required mortgage lenders to give consumers two different, overlapping disclosures within three business days after receiving a mortgage application, and again at or shortly before closing. These forms contained duplicative information that could be confusing to consumers and unnecessarily burdensome for businesses. Pursuant to the Dodd-Frank Act, the Bureau worked to simplify and streamline this information. In November, after more than two years of extensive research, testing, and review, the Bureau issued a rule requiring easier-to-use mortgage disclosure forms that clearly lay out the mortgage terms and costs for homebuyers.

In addition, our Research, Markets, and Regulations Team is studying the costs of complying with existing regulations. To further that effort, we have sought qualitative information on the impact of regulations on financial service providers so that we can better understand the compliance activities, burdens, and other economic costs and benefits of regulations. Based on some of the information we received, we recently issued a public report on the costs that banks incur to comply with regulations governing consumer deposit-related products and services. This report marks an important step towards the Bureau's goal of learning more about compliance costs and identifying meaningful opportunities to avoid imposing unnecessary operational costs.

Going forward, we will continue to look back to assess the benefits and costs of the regulations we issue. Currently, we are developing a comprehensive plan to assess the effectiveness of the significant rules that we adopt under Federal consumer financial law within five years of their issuance, as Section 1022 of the Dodd-Frank Act requires. Before we publish a report assessing our regulations, we'll seek public comment on the regulations and on recommendations for changing them.

Facilitate compliance

Fourth, in addition to eliminating unwarranted regulatory burdens where feasible, we are working to make it as easy as possible to comply with our regulations. To that end, we have implemented comprehensive regulatory implementation programs to help industry comply with our rules. For example, in the lead-up to the October 2013 effective date of our rule on international remittance transfers, we created a downloadable Small Entity Compliance Guide providing an overview of the rule's requirements, a video summarizing the rule, and a webpage containing those and other key resources. In addition, Bureau staff participated in industry forums and conferences, and routinely answered informal guidance questions, to help industry meet their obligations under the new rule.

Similarly, after we issued new mortgage rules last January, we published plain-language compliance guides and video presentations that give an overview of the rules. In close coordination with other regulators, we also developed and issued examination procedures as early as practicable to help the implementation process. In addition, we issued a readiness guide and other implementation materials, all of which are available on an implementation-specific page on our website. That one-stop shop is designed to make compliance materials more accessible for a broad array of industry constituents, particularly smaller businesses with limited legal and compliance staff. To supplement these resources, we also provide informal oral guidance to industry participants who contact us with interpretive questions.

As we worked to help industry to implement the new mortgage rules, stakeholders raised questions and concerns about various issues. Where warranted, we responded by proposing and issuing amendments and clarifications to facilitate compliance and better protect consumers. To take just one example, creditors and loan originators expressed concern about new requirements for persons classified as loan originators to have certain qualifications and not to be compensated in certain ways. In particular, industry participants explained that tellers or other administrative staff could be unintentionally classified as loan originators subject to these requirements simply

by engaging in routine customer service activities. In response to this concern, we amended our loan originator rule to clarify the limited circumstances in which administrative staff members qualify as "loan originators" subject to the rules. As another example, we amended our rules to make it easier for servicers to offer short-term forbearance plans for delinquent borrowers who need only temporary relief without going through a full loss-mitigation evaluation process. By addressing the issues that arose during the implementation process, we aim to produce better compliance and better protections for consumers.

Hold parties accountable for violations of law

Of course, despite our best efforts, not everyone complies with the law all the time. That brings me to our fifth strategy for helping to make financial markets work better for consumers: holding parties who violate the law accountable through an effective supervision and enforcement program. Through our supervision program, we examine a variety of banks and nonbanks for compliance with federal consumer protection law. To ensure that we use our supervisory resources most effectively, we take a risk-based approach to conducting examinations. In particular, we assess various factors in deciding which entities to examine so that we can direct our resources to the products and markets that pose the greatest risks to consumers. Similarly, our Office of Enforcement has focused its investigative resources on violations of law that cause the greatest harm to consumers. Together, our supervision and enforcement programs have returned hundreds of millions of dollars to injured consumers, halted violations of law, and required companies to strengthen their compliance systems.

Support innovation in the market

Finally, the sixth strategy we employ to help make consumer financial markets work better is to support innovations in the market. We believe that looking at problems and solutions from new angles can produce important insights and innovations that will help achieve our vision of a consumer finance market that works well for all consumers. To help make this vision a reality, we launched "Project Catalyst" to support innovators in creating consumer-friendly financial products and services. As one aspect of this project, we have invited innovators to collaborate with us on changes that could serve consumers. In particular, the public may propose changes in financial regulation that could better foster consumer-friendly innovation, or they may share an idea for a new, consumer-friendly financial product or service and ask to collaborate with us in developing it.

Another part of Project Catalyst is our trial disclosure program. Under this program, companies can design an innovative disclosure or way of delivering a disclosure that is not permissible under existing regulations. Where appropriate, we will grant a waiver from compliance with the existing regulations, with safeguards in place to protect against consumer harm, so that the company can try out its idea and measure how well it works. We will then be able to review the data from the trial disclosure to help determine whether the proposed innovation works better than what is currently required.

All of these strategies play an important part in our work to promote well-functioning markets for consumer financial products and services that are fair, transparent, and competitive.

Conclusion

Thank you again for the opportunity to discuss the impact of regulation on financial markets and institutions with the Committee. We look forward to carrying out our responsibilities under the Dodd-Frank Act to strengthen the financial services market for consumers.

NCUA
National Credit Union Administration

Embargoed until Delivery
10:00 a.m. Eastern
April 8, 2014

Congressional Testimony

Michael J. McKenna
General Counsel
National Credit Union Administration

House Financial Services Committee
Tuesday, April 8, 2014

NCUA
National Credit Union Administration

Congressional Testimony

Introduction

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, the National Credit Union Administration appreciates the invitation to provide its views on the agency's recent regulatory and supervisory activities and their effects on federally insured credit unions, consumers, and the financial services marketplace.

I am Michael J. McKenna. I have worked for NCUA in various capacities since 1989, including as a staff attorney, Senior Policy Advisor, Deputy Executive Director, and Deputy General Counsel. Since August 2011, I have served as NCUA's General Counsel. In this role, I have the responsibility for managing all legal matters affecting NCUA.

As a starting point, I want to emphasize that NCUA understands the need to strike a proper balance between implementing the safety and soundness considerations required by the Federal Credit Union Act and minimizing the bottom-line impact for the credit unions we regulate and insure. NCUA has a tailored program designed to mitigate compliance costs and improve the examination process for all credit unions. Rather than adopting one-size-fits-all regulations, NCUA focuses the agency's rules on risk and asset size.

In the invitation to testify, the Committee asked NCUA to review the agency's recent regulatory and supervisory activities. The invitation also asked several questions related to the use of cost-benefit analyses in rulemakings, the effects of rulemakings on the marketplace, the access of consumers to products, and the agency's rulemaking procedures.

To answer these questions, this testimony will provide general background about NCUA, its rulemaking process, and recent regulatory activities. This testimony will also highlight recent developments affecting NCUA's rulemakings and explore how rules affect product availability. Additionally, this testimony will briefly detail NCUA's examination process, which seeks to limit compliance costs for small, non-complex credit unions.

Finally, this testimony will discuss the agency's ongoing efforts to reduce regulatory compliance requirements and address emerging risks. Since the inception of NCUA Board Chairman Debbie Matz's Regulatory Modernization Initiative in 2011, the NCUA Board has approved six rules to reduce regulatory burdens and four targeted rules to mitigate safety and soundness concerns. These four rules also exempt two-thirds of all credit unions from regulatory requirements. The ongoing success of the initiative demonstrates NCUA's commitment to reducing compliance requirements and adopting flexible rules targeting risk to ensure the continued safety and soundness of the credit union system.

NCUA's Mission

NCUA's primary mission is to provide, through regulation and supervision, a safe and sound credit union system, which promotes confidence in the national system of cooperative credit. NCUA performs this important public function by:

- Examining all federal credit unions.
- Participating in the supervision of federally insured, state-chartered credit unions in coordination with state regulators.
- Insuring individual accounts at federally insured credit unions up to $250,000 and joint accounts up to $250,000 per member.

As required by the Federal Credit Union Act, NCUA serves as the administrator of the $11.6 billion National Credit Union Share Insurance Fund.[1] In this role, NCUA provides oversight and supervision to 6,554 federally insured credit unions. Of these credit unions, NCUA directly supervises the 4,105 federal credit unions that the agency chartered.

Currently, federally insured credit unions represent 98 percent of all credit unions and serve 96.3 million credit union members.[2]

Rulemaking and Review Processes

In developing new rules and revising existing ones, NCUA follows the requirements of the Federal Credit Union Act and other applicable laws. NCUA's unique rolling three-year review of every NCUA regulation also guides many of the agency's regulatory efforts.

Regulation Review

Since 1987, NCUA has followed a well-delineated and deliberate process to continually review its regulations and give the public the opportunity to comment. NCUA conducts a rolling review of one-third of all its regulations each year, meaning that the agency reviews all of its regulations at least once every three years. This process ensures that NCUA's regulations are up-to-date, effective, and reflect the current environment.

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[1] Congress established the National Credit Union Share Insurance Fund in 1970 as part of the Federal Credit Union Act (P.L. 91-468) and amended the Share Insurance Fund's operations in 1984 (P.L. 98-369). The fund operates as a revolving fund in the U.S. Treasury under the administration of the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state-chartered credit unions that request federal insurance. Funded by federally insured credit unions, the Share Insurance Fund is backed by the full faith and credit of the United States.
[2] NCUA does not oversee approximately 133 state-chartered, privately insured credit unions. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

This long-standing regulatory review policy helps to ensure NCUA's regulations:

- Impose only the minimum required burdens on credit unions, their members, and the public.
- Are appropriate for the size of the credit union regulated by NCUA.
- Are issued only after full public participation in the rulemaking process.
- Are clear and understandable.

This rolling review is fully transparent. On its website every year, NCUA publishes the list of the applicable regulations up for review that year and invites public comment on any or all of the regulations.[3]

Rulemaking Considerations

NCUA recognizes the importance of minimizing the compliance costs associated with new rules, particularly for small, non-complex credit unions. Therefore, the agency will not engage in formal rulemaking unless there is a clear need for a rule.

Before engaging in formal rulemaking under the Administrative Procedure Act, NCUA conducts an analysis about the need for and impact of a potential rule and the associated costs and benefits. NCUA also gathers information from stakeholders, including comments received as part of NCUA's rolling regulatory review and interactions with credit unions, trade associations, state regulators, and other interested parties. NCUA additionally performs extensive research on applicable topics related to a potential rule.

Occasionally, NCUA issues an advance notice of proposed rulemaking in the *Federal Register*. In this notice, the agency identifies its initial analysis on a particular subject without imposing any proposed requirements. NCUA uses this procedure as a tool for gathering public comments and information before committing to a regulatory direction. For example, NCUA issued advance notices of proposed rulemaking in 2011 and 2012 before proposing regulations on emergency liquidity and derivatives. These notices informed the development of the proposed rules.

When updating or issuing new rules, NCUA complies with the applicable statutes. For example, NCUA follows the Administrative Procedure Act to ensure proper public input. NCUA also adheres to the Plain Writing Act to make certain that the agency's rules are clear and understandable. NCUA additionally follows the requirements of the Paperwork Reduction Act to estimate paperwork compliance costs.

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[3] See http://www.ncua.gov/Legal/Regs/Pages/Regulations.aspx.

Evaluating Costs and Benefits

NCUA strives to ensure that the agency's rulemakings are reasonable and cost-effective.

Many of NCUA's regulations strengthen the safety and soundness of the credit unions the agency supervises. These safety and soundness regulations are designed to reduce the likelihood of credit union failures and, in doing so, protect the National Credit Union Share Insurance Fund from losses. Any loss to the Share Insurance Fund is ultimately borne by surviving credit unions, which may be required to pay increased premiums. As member-owned cooperatives, this means the members who are the owners and customers of the credit unions may ultimately repay these costs. As the developments of the last decade have demonstrated, the cost of regulatory inaction can result in failures that impose a greater cost to credit unions than the cost of action.

When considering regulatory changes, the NCUA Board considers both the direct and indirect potential costs, as well as the potential benefits. Direct costs include any expenses credit unions are likely to incur in complying with the rule. These costs might include the additional time spent collecting data, reporting, and training staff, as well as the need to acquire new software or services. Indirect costs might include higher lending rates or fees, lower rates on share deposits, or other unintended constraints on credit union activities for their members.

The NCUA Board also uses the public comment process to gain insight on potential costs and unintended consequences directly from the credit unions the agency supervises and insures. A good example of this process is NCUA's final rule on emergency liquidity. The proposed rule applied to all federally insured credit unions with more than $50 million in assets. The public comment period yielded a number of important comments from credit unions about the compliance requirements associated with establishing emergency lines of credit.

Based on this information, the NCUA Board reconsidered the balance between costs and benefits for credit unions between $50 million and $250 million in assets. In the final rule, the NCUA Board exempted these credit unions from establishing emergency lines of credit. Instead, the NCUA Board only required these credit unions to develop contingency funding plans that clearly set out strategies for meeting emergency liquidity needs.

As noted above, the benefits associated with NCUA's rules are primarily derived from addressing and mitigating risks in order to reduce the likelihood of credit union failures. By mitigating failures, NCUA protects the Share Insurance Fund and, in so doing, limits the financial burdens placed on surviving credit unions, which bear the costs of any failures.

The collapse of five corporate credit unions during the financial crisis best illustrates this point. To date, credit unions have paid $4.8 billion in assessments and experienced $5.6 billion in losses in the form of contributed capital.[4] These costs reduced credit union earnings and capital and, as a result, may have decreased interest paid on share deposits, increased loan rates, and constrained credit union services for their members.

Effect on the Marketplace

In addition to the services credit unions offer their members, independent research has shown that credit unions provide benefits to non-members by creating competition in the marketplace. This results in better loan rates for consumers in markets with robust credit union participation.[5]

In developing or devising any rule, the NCUA Board and staff will consider the effect on the credit union system and the broader financial services marketplace. Credit unions are an important part of the nation's financial services infrastructure. As member-owned cooperatives, credit unions focus on serving their members. According to the Federal Reserve's *Financial Accounts of the United States*, credit union loans accounted for 8.4 percent of all lending by U.S. chartered depository institutions at the end of 2013, an increase of 1.1 percentage points since 2009.

NCUA is not aware of any regulatory action the agency has taken that has eliminated the availability of permissible products for credit union members. NCUA closely monitors lending trends and maintains open lines of communication with stakeholders. If it is determined that a rule is having unintended adverse consequences, such as decreasing the availability of financial services products, NCUA staff would immediately notify the NCUA Board and offer alternatives.

Public Awareness and Input

NCUA is committed to providing transparency in the rulemaking process. NCUA publishes every proposed and final rule in the *Federal Register*. NCUA also notifies the Office of Management and Budget of items for inclusion in the Administration's "Unified Agenda" every six months.

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[4] NCUA is actively working to mitigate the assessments that credit unions need to pay by holding accountable those Wall Street firms that sold faulty mortgage-backed securities to the five failed corporate credit unions. Since 2011, NCUA has recovered more than $1.75 billion through the agency's legal actions. These recoveries, combined with improving legacy asset performance, have continued to improve the outlook of projected loss estimates. NCUA remains committed to holding accountable those that contributed to the corporate credit union failures. At the end of 2013, NCUA had 15 lawsuits pending against Wall Street firms. In addition, NCUA filed suit against 13 banks in 2013 alleging violations of federal and state antitrust laws by their manipulation of interest rates in the London Interbank Offered Rate system.
[5] See, for example, Feinberg, Robert M., "The Determinants of Bank Rates in Local Consumer Lending Markets: Comparing Market- and Institution-Level Results," Southern Economic Journal 70 (2003), 144-156.

Every proposed rule is released for a comment period, typically 60 days, which provides sufficient time for public review and input. In some instances, if a proposed rule is particularly complex, a longer comment period may be provided. This is the case on risked-based capital; the comment period will close 125 days after the rule was proposed. After the comment period closes, NCUA carefully reviews and summarizes all comments.

The NCUA Board generally makes changes to proposed rules based on the comment letters received from credit unions, the general public, and other interested parties. Often, it is the comments of credit unions that most directly affect the content of the agency's final rules. The process of soliciting and carefully considering comments on proposed rules has resulted in better regulations.

Recent Regulatory Activities

Under NCUA's ongoing Regulatory Modernization Initiative, the agency seeks to update and streamline existing regulations to reduce compliance requirements or expand the powers of credit unions, consistent with the law and without jeopardizing safety and soundness. Overall, NCUA also seeks to issue and enforce flexible, calibrated, and risk-focused regulations that take into account the size of the credit union to minimize regulatory obligations, where possible.

Rulemaking Overview

In recent years, NCUA's regulatory activities can generally be classified as:

- Enhancing the system's safety and soundness in response to the lessons learned from the recent financial crisis or the identification of growing potential risks.
- Implementing the requirements of statutes like the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Addressing recommendations made by the Government Accountability Office or NCUA's Office of the Inspector General.
- Providing regulatory relief both through rulemaking and other actions, such as supervisory guidance, policy statements, and streamlined examinations.
- Clarifying technical issues.

In 2013 and 2014, the NCUA Board approved 17 final rules. Of these rules, one rule was required by the Dodd-Frank Act, five rules provided regulatory relief, and four rules addressed safety and soundness matters. Seven rules were technical or clarifying. Figure 1 summarizes these 17 rulemakings by each of these categories.

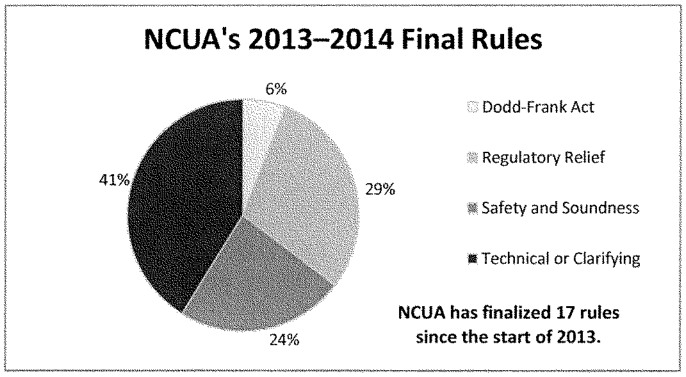

Figure 1

Stated another way, 70 percent of NCUA's recent final rules have provided regulatory relief or greater clarity without imposing new compliance costs. In the four instances where a new rule created a compliance cost under the Paperwork Reduction Act, NCUA has worked to minimize the burden on credit unions in complying with the new rule.

Remaining Financial Crisis Responses

Since the financial crisis of 2007 through 2009, NCUA has issued several rules designed to enhance safety and soundness. The agency has two planned post-crisis rulemakings remaining. One is the agency's risk-based capital rule; the other is a proposed rule requiring capital planning and stress testing for federally insured credit unions with assets exceeding $10 billion. Both proposed rules would mitigate risks to the Share Insurance Fund.

The NCUA Board proposed the risk-based capital rule on January 23, 2014. The extended comment period on this proposed rule, one of the longest in NCUA's history, will close May 28. Under the proposed rule, only the 3 percent of federally insured credit unions that take higher risks would be required either to reduce those risks or to hold more capital. However, credit unions would not be required to hold capital at a level above the risk-based well capitalized threshold, as some stakeholders have stated. The proposed risk-based capital also exempts two-thirds of credit unions, those with less than $50 million in assets, because they are not considered complex. Based on losses from several larger credit unions incurred during the past crisis, a final risk-based rule will be critical to protecting against future losses.

Likewise, stress tests are forward-looking measures. NCUA's proposed stress testing rule is designed to determine whether a credit union is holding an adequate capital position to survive adverse scenarios and to allow credit unions to make adjustments before a crisis

hits. The proposed rule would bring affected credit unions in line with changes made by the Dodd-Frank Act, which requires certain financial services entities with more than $10 billion in assets to conduct annual stress tests.

Under the proposed rule, a credit union that fails a stress test would be required to develop a capital enhancement plan to demonstrate how it would meet minimum stress test capital ratios. Before taking action on a capital plan submitted by a federally insured, state-chartered credit union, NCUA would consult with the state regulator. A credit union that passes the test would benefit from the analysis by identifying potential improvements in its enterprise risk management system. Currently, only 4 of the 6,554 credit unions that NCUA regulates and insures would have to take any action under this proposed rule.

NCUA's Office of National Examinations and Supervision would oversee the stress testing, which would be based on scenarios issued each year by the Federal Reserve. The comment period for this proposed rule ended at the end of 2013, and the NCUA Board anticipates approving a final rule later this year.

Recent Developments Impacting Regulation

A number of legislative and administrative developments have impacted NCUA's regulatory program in recent years.

Statutory Requirements

The enactment of the Dodd-Frank Act in 2010 resulted in all federal financial services regulators, including NCUA, adopting a number of reforms aimed at addressing regulatory shortcomings and preventing future financial crises.

NCUA has acted diligently to implement the required reforms applicable to credit unions. For instance, in September 2010, the NCUA Board approved a final rule making permanent the $250,000 per account limit on share insurance coverage. In December 2012, the NCUA Board adopted a final rule to require new standards for judging the creditworthiness of investments. To date, NCUA has finalized ten actions related to the Dodd-Frank Act.

In recent years, NCUA has also participated in a number of interagency rulemakings. These rulemakings relate to actions required by the Dodd-Frank Act or other laws enacted by Congress. NCUA greatly appreciates the cooperative relationships which have been strengthened with other agencies as a result of these joint rulemakings. Currently, NCUA

has several joint agency rulemakings pending, including proposed rules on flood insurance, and appraisal management companies.[6]

GAO and OIG Recommendations

NCUA has additionally acted on regulatory matters in response to the recommendations of the Government Accountability Office and NCUA's Office of the Inspector General. In January 2012, GAO released a report, *Earlier Actions Are Needed to Better Address Troubled Credit Unions*.[7] The report recommended that NCUA make changes to the agency's prompt corrective action rule, including updating risk-based capital standards for credit unions.

Additionally, NCUA's OIG has issued multiple material loss reviews for failed credit unions from 2009 to the present. These reviews have included recommendations for NCUA to prevent future losses, including strengthening safety and soundness regulations including the agency's risk-based capital rule. As noted earlier, NCUA issued its proposed rule on risk-based capital on January 23, 2014.

Executive Order 13579

On July 11, 2011, President Obama issued Executive Order 13579 requesting that independent agencies take steps to ensure regulations are cost-effective and designed to promote economic growth and job creation. While NCUA already met or exceeded the Executive Order's key principles, NCUA Board Chairman Matz announced the agency's Regulatory Modernization Initiative in September 2011. Under the initiative, NCUA is working to eliminate or streamline ineffective or overly burdensome regulations. Additionally, NCUA is developing targeted regulations that address high-risk activities.

Some of the actions taken by NCUA under the Regulatory Modernization Initiative include:

- Permitting eligible credit unions to use basic derivatives to hedge interest rate risk.
- Simplifying the process for credit unions to receive a low-income designation.
- Streamlining Community Development Revolving Loan Fund loan applications.
- Easing the reporting of troubled debt restructurings to keep people in their homes.

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[6] Although the Dodd-Frank Act requires NCUA to issue the proposed joint agency rule on minimum requirements for appraisal management companies, NCUA will not be able to enforce it. Presently, NCUA is the only federal financial institutions regulator lacking the necessary authority to examine third-party vendors for safety and soundness and compliance with laws and regulations. NCUA has asked Congress to provide vendor authority under the Federal Credit Union Act to mitigate this regulatory blind spot.

[7] See GAO-12-247 available at http://www.gao.gov/assets/590/587409.pdf.

Through the Regulatory Modernization Initiative, NCUA is also adopting rules to address new risks and update outdated or insufficient rules. Such rules address lessons learned during the recent crisis. Recent actions related to this objective include final rules to:

- Mitigate interest rate risk.
- Plan for emergency liquidity.
- Enhance the risk transparency of credit union service organizations.
- Protect buyers of loan participations.

Reducing Regulatory Burdens

In addressing regulatory burdens, credit unions sometimes raise concerns stemming from other regulators such as the Financial Crimes Enforcement Network, which sets the standards for compliance with the Bank Secrecy Act. NCUA has no ability to provide regulatory relief in these instances. However, NCUA does work to reduce regulatory burdens where possible, including by targeting rules and examinations for small credit unions and increasing the number of credit unions with the low-income designation.

Small Credit Unions

NCUA aims to target the agency's regulations to risk and asset size, rather than adopting one-size-fits-all rules. In this regard, NCUA is particularly sensitive to the impact that rulemakings have on small, non-complex credit unions.

These credit unions have limited resources to comply with new regulations. In fact, for credit unions with less than $50 million in assets the median number of employees is 3.5 full-time equivalent staff. Because they do not pose substantial risk exposure to the Share Insurance Fund, NCUA exempts small, non-complex credit unions from new NCUA rules or eases compliance costs for them whenever feasible.

For example, at the start of 2013, the NCUA Board approved a final rule that updated the definition of a small credit union from the former threshold of less than $10 million in assets to the new threshold of less than $50 million in assets. As a result of this regulatory change, two-thirds of federally insured credit unions are exempted from the risk-based net worth regulatory requirements under NCUA's existing prompt corrective action rule. Credit unions with less than $50 million in assets are also exempted from the requirement to adopt and implement interest rate risk policies. In addition, 2,270 more credit unions became eligible for assistance from NCUA's Office of Small Credit Union Initiatives, including access to free training sessions and consulting services.

Since adopting the new asset threshold for defining small credit unions, NCUA has finalized a rule on emergency liquidity for credit unions. This scaled regulation places the smallest burden on credit unions with less than $50 million in assets.

Going forward, the NCUA Board will continue to consider the $50 million asset threshold for additional regulatory relief when issuing rules for credit unions. NCUA plans to revisit this threshold in 2015 and then every three years to ensure that the level accurately measures the size of small, non-complex credit unions in a rapidly changing marketplace.

Low-Income Credit Unions

Low-income credit unions play an important role in their communities and are often the only federally insured institutions serving underserved and unbanked populations. These credit unions can promote greater financial security for their members. Growth in the number of credit unions with the low-income designation could provide additional opportunities for investment in local economies.

To qualify as a low-income credit union, a majority of a federal credit union's membership must meet low-income thresholds based on 2010 Census data. Under the Federal Credit Union Act, the low-income designation offers several benefits including:

- Eligibility for Community Development Revolving Loan Fund grants and low-interest loans.
- Ability to accept deposits from non-members.
- Authorization to obtain supplemental capital.
- Expanded member business lending authority, which increases access to capital for small businesses and helps to diversify credit unions' portfolios.

In August 2012, NCUA Board Chairman Matz announced an initiative to significantly streamline the application process for federal credit unions to secure a low-income designation. In February 2013, NCUA expanded the initiative as a result of an agreement with the National Association of State Credit Union Supervisors and state regulators to expedite the approval process for federally insured, state-chartered credit unions.

By the end of 2013, NCUA's initiative to simplify the low-income designation process resulted in 1,986 credit unions across the country carrying the designation, nearly double the number from when the initiative began. Together, these credit unions have 20.1 million members and $177.9 billion in assets.

Supervision of Credit Unions

NCUA continues to use a risk-focused approach when conducting examinations of credit unions. In addition, NCUA utilizes an annual examination program. Begun in 2009 and fully phased in by 2012, this program requires annual examinations of all federal credit unions regardless of asset size, and all federally insured, state-chartered credit unions with more than $250 million in assets. The program allows NCUA examiners to identify and work with credit unions to correct issues earlier to avoid greater costs to the Share Insurance Fund later on.

To decrease the amount of time spent on exams in small credit unions, NCUA has conducted expedited exams since 2012 at credit unions with under $10 million in assets and which are financially and operationally sound. These very small credit unions pose limited exposure to the Share Insurance Fund. The streamlined examinations focus on pertinent areas of risk found in these types of institutions, such as lending, recordkeeping, and auditing. This shortened exam process also allows the smallest credit unions more time to focus on serving their members.

Additionally, NCUA is now in the process of applying the streamlined examination program for credit unions with assets between $10 million and $50 million. When implemented, this program will further reduce the examination requirements for eligible credit unions.

Conclusion

NCUA appreciates the need to strike a proper balance between the Federal Credit Union Act's safety and soundness requirements and minimizing the regulatory burdens of credit unions. To do this, NCUA has in place a calibrated regulatory program designed to mitigate compliance costs. NCUA also aims to target the agency's regulations to risk and asset size, rather than adopting one-size-fits-all rules.

To further reduce regulatory burdens, NCUA remains committed to continuing its rolling three-year review of the agency's rules. This program ensures that NCUA's regulations reflect and keep up with marketplace realities. NCUA will also continue efforts to streamline examinations for small, non-complex credit unions. Finally, NCUA is committed to working with Congress and other stakeholders to explore other ways to improve NCUA's rules and the examination process.

I look forward to answering any questions the Committee may have.

STATEMENT OF

RICHARD J. OSTERMAN, JR.
ACTING GENERAL COUNSEL
FEDERAL DEPOSIT INSURANCE CORPORATION

on

REGULATORY ACTIVITY OF THE FDIC

before the

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

April 8, 2014
2128 Rayburn House Office Building

Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify today on the recent regulatory activity of the Federal Deposit Insurance Corporation (FDIC).

My testimony will address several topics. First, I will discuss the improving state of the industry following the financial crisis. I will then address recent regulatory activity of the FDIC, including actions related to capital and liquidity requirements, and credit risk retention. Finally, I will describe our efforts to tailor regulations and our supervisory approaches for community banks in recognition of the unique role they play in the financial system.

Improving State of the Industry

The banking industry in the United States continues to experience gradual but steady improvement since the financial crisis. Asset quality has improved; there are fewer troubled institutions; and capital and liquidity ratios are stronger.

Annual earnings in the industry have increased for the past four years. FDIC-insured commercial banks and savings institutions reported aggregate net income of $40.3 billion in the fourth quarter of 2013, a $5.8 billion (16.9 percent) increase from a year ago. Over half (53.0 percent) of the 6,812 FDIC-insured institutions in the fourth quarter reported a year-over-year increase in earnings. The proportion of banks that were unprofitable in the fourth quarter fell to 12.2 percent from 15.0 percent a year earlier.

Balance sheets in the industry also have improved. Net charge-offs have posted a year-over-year decline for 14 consecutive quarters, and noncurrent loan balances have declined for 15 consecutive quarters. Importantly, loan balances for the industry as a whole have grown in nine out of the last 11 quarters. These positive trends have been broadly shared across the industry among large institutions, mid-size institutions, and community banks.

Other indicators of industry conditions have been moving in a positive direction. The number of banks on the FDIC "Problem List"—those institutions with the lowest supervisory CAMELS ratings of 4 or 5—peaked in March 2011 at 888 institutions. By December 2013, the number of problem banks had dropped to 467. The number of bank failures also has been declining steadily. Bank failures peaked in 2010 at 157. In 2013, there were 24 bank failures.

Another sign of the improving health of the banking industry is the decline in the number of enforcement actions by the FDIC. The total number of FDIC enforcement actions, both formal and informal, decreased by 27 percent last year, from 775 in 2012 to 567 in 2013. Last year, for the first time since 2008, the total number of enforcement actions terminated outpaced the number of enforcement actions issued.

Despite these positive trends, the banking industry still faces a number of challenges. For example, although credit quality has improved, delinquent loans and charge-offs remain at elevated levels. In addition, tighter net interest margins and relatively modest loan growth have created incentives for institutions to reach for yield in

their loan and investment portfolios, which has heightened their vulnerability to interest rate risk. The federal banking agencies have reiterated their expectation that banks manage risk in a prudent manner. Interest rate risk is an ongoing concern for bank regulators, and it will continue to be a focus of attention in safety and soundness examinations.

The Deposit Insurance Fund

As the industry has recovered over the past few years, the Deposit Insurance Fund (DIF) also has moved into a stronger financial position.

The Dodd-Frank Act raised the minimum reserve ratio for the DIF (the DIF balance as a percent of estimated insured deposits) from 1.15 percent to 1.35 percent, and required that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline, and the DIF reserve ratio is recovering at a pace that remains on track under the Plan. As of December 31, 2013, the DIF reserve ratio stood at 0.79 percent of estimated insured deposits, up from 0.68 percent at September 30, 2013, and from 0.44 percent at year-end 2012.

The fund balance has grown every quarter for the past four years and stood at $47.2 billion at December 31, 2013. This is in contrast to the negative $21 billion fund balance at its low point at the end of 2009. Assessment revenue, fewer anticipated bank

failures, and lower estimated losses on failed bank assets have been the primary drivers of the growth in the DIF balance.

Regulatory Activity

Capital and Liquidity Requirements

Interagency Rulemakings on Basel III and the Supplementary Leverage Ratio

In July 2013, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC joined the Federal Reserve Board and the OCC in issuing rules that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III capital standards adopted by the Basel Committee on Banking Supervision (Basel Committee) and certain requirements of the Dodd-Frank Act (Basel III rulemaking). Second, these agencies also issued a notice of proposed rulemaking (Enhanced Supplemental Leverage Ratio NPR) that would strengthen leverage capital requirements for eight of the largest and most systemically important U.S. bank holding companies (BHCs) and their insured banks.

The Basel III rulemaking substantially strengthens both the quality and the quantity of risk-based capital for all banks in the U.S. by placing greater emphasis on common equity tier 1 capital. Common equity tier 1 capital is widely recognized as the most loss-absorbing form of capital, and the Basel III changes are expected to result in a stronger, more resilient industry better able to withstand periods of economic stress in the future. The Basel III rulemaking also includes a new supplementary leverage ratio

requirement, as provided in the Basel III framework. This represents an important enhancement to the international capital framework. Finally, in response to industry comments on the proposal, the Basel III rulemaking includes provisions designed specifically to reduce burden on smaller banking organizations. The Basel III rules are effective on January 1, 2015, for banking organizations that are not subject to the advanced approaches risk-based capital rules. This timeframe provides most banks with an additional year to implement the rules, as compared to the largest organizations that are subject to the advanced approaches. While most banks already meet the Basel III requirements, those that need more time will benefit from the rule's extended phase-in period.

As noted above, the agencies also issued an Enhanced Supplementary Leverage Ratio NPR, which proposes enhanced supplementary leverage standards for eight large and systemically important BHCs and their insured banks. The NPR would require covered IDIs to satisfy a six percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. BHCs covered by the Enhanced Supplementary Leverage Ratio NPR would need to maintain a supplementary leverage ratio of at least five percent (a three percent minimum plus a two percent buffer) to avoid restrictions on capital distributions and executive compensation.

Higher leverage capital requirements would help reduce the risk these institutions pose to the financial system and would also put additional private capital at risk before the DIF and the FDIC's resolution mechanisms would be called upon. The issuance of

the Enhanced Supplementary Leverage Ratio NPR is one of the most important steps the banking agencies could take to strengthen the safety and soundness of the U.S. banking and financial systems. The comment period for the Enhanced Supplementary Leverage Ratio NPR ended on October 21, 2013. The FDIC Board is considering a final rule on the supplementary leverage ratio later today.

Rule on the Liquidity Coverage Ratio and the Net Stable Funding Ratio Proposal

A number of large financial institutions experienced significant liquidity problems during the financial crisis that exacerbated stress on the banking system and destabilized the financial system. In response, in October 2013, the FDIC, together with the OCC and the Federal Reserve Board, issued an interagency proposed rule to implement a quantitative liquidity requirement consistent with the Liquidity Coverage Ratio (LCR) developed by the Basel Committee on which the U.S. banking agencies serve as members. The comment period on this proposal closed on January 31, 2014, and the agencies are in the process of reviewing the more than 100 comments received.

Risk Retention

On August 28, 2013, the FDIC Board approved a NPR issued jointly with five other federal agencies to implement the credit risk retention requirement set forth in Section 941 of the Dodd-Frank Act, which seeks to ensure that securitization sponsors have appropriate incentives for prudent underwriting.[1] The proposed rule generally requires that the sponsor of any asset-backed security (ABS) retain an economic interest

[1] Credit Risk Retention, 78 Fed. Reg. 57,928 (proposed Sept. 20. 2013), http://www.fdic.gov/regulations/laws/federal/2013/2013-09-20_proposed-rule.pdf.

equal to at least five percent of the aggregate credit risk of the collateral. This is the second proposal under Section 941; the first was issued in April 2011.

The current NPR provides the sponsors of ABSs with various options for meeting the risk retention requirements. As required by the Dodd-Frank Act, the proposed rule defines a "qualified residential mortgage" (QRM), that is, a mortgage which is statutorily exempt from risk retention requirements. The NPR would align the definition of QRM with the definition of "qualified mortgage" (QM) as prescribed by the Consumer Financial Protection Bureau (CFPB) in 2013. The NPR also includes a request for public comment on an alternative QRM definition that would add certain underwriting standards to the existing QM definition. Similar to the prior proposal, the current proposal sets forth criteria for securitizations of commercial real estate loans, commercial loans, and automobile loans that meet certain conservative credit quality standards to be exempt from risk retention requirements.

The FDIC received over 200 comments on the current NPR. A number of comments relate to risk retention issues regarding open market collateralized loan obligations (CLOs).[2] The proposed rule considers an open market CLO manager to be a securitization sponsor and, therefore, the manager would generally be required to retain five percent of the credit risk of CLO issuances. As an alternative, managers or sponsors could satisfy the risk retention requirement if the lead arrangers of the loans (typically the

[2] An open market CLO is defined as one (i) whose assets consist of senior, secured syndicated loans acquired directly from the sellers in open market transactions and of servicing assets, (ii) that is managed by a CLO manager, and (iii) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.

main lender) purchased by the open market CLO retained the required risk. Some commenters have argued that the lead arranger option is unworkable and that the proposal would significantly affect the formation and continued operation of CLOs, and that this could reduce the volume of commercial lending. The agencies are continuing to review comments and meet with interested groups to discuss their concerns and will give full consideration to all issues raised before issuing the final rule.

Review of Resolution Plans

As required by the Dodd-Frank Act, the FDIC is developing a framework for the resolution of a systemically important financial institution (SIFI) in the event of a failure. Under the Act, bankruptcy is the preferred option for dealing with the failure of a SIFI that is not itself an insured depository institution. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of $50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or "living wills," to demonstrate how the company could be resolved in a rapid and orderly manner under the U.S. Bankruptcy Code in the event of the company's financial distress or failure.

The 165(d) Rule, jointly issued by the FDIC and the Federal Reserve Board in 2011, implemented the requirements for resolution plans and provided for staggered annual submission deadlines based on the size and complexity of the companies. Eleven of the largest, most complex institutions submitted initial plans in 2012 and revised plans

in 2013. In 2013, another 120 institutions submitted initial resolution plans under the 165(d) Rule. In addition, the FSOC designated three non-bank financial institutions for Federal Reserve Board supervision. These firms are expected to submit initial resolution plans in 2014, along with five additional institutions that have qualified as covered companies under the 165(d) Rule in the period following its issuance.

The Federal Reserve Board and FDIC are charged with reviewing the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient, the Federal Reserve Board and FDIC must notify the filer of the areas in which the plan is deficient. The filer must resubmit a revised plan that adequately addresses the deficiencies within 90 days (or other specified timeframe).

Following the review of the initial resolution plans submitted in 2012, the Federal Reserve Board and FDIC issued guidance for the eleven initial firms concerning the information that should be included in their 2013 resolution plan submissions. The guidance identified an initial set of significant obstacles to rapid and orderly resolution that the firms are expected to address in the plans, including the actions or steps a company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions.

Developing Regulatory Approaches

The FDIC has an ongoing commitment to ensure that its regulations and policies achieve legislative and regulatory goals in the most efficient and effective manner possible. As a key component, the FDIC has long recognized the necessity of carefully considering all available information relating to the benefits and costs of new regulations to ensure that they effectively promote financial stability without placing undue burden on insured depository institutions and the public. Last year, the FDIC Board of Directors reviewed and updated its Policy Statement on the Development and Review of FDIC Regulations and Policies.[3] This Policy Statement sets out a number of principles governing the development and review of all FDIC regulations and policies, including the evaluation of benefits and costs based on available information, and the consideration of reasonable and possible alternatives. Particular attention is focused on the impact that a regulation will have on small institutions and whether there are comprehensive or targeted alternatives to accomplish the FDIC's goal which would minimize any burden on small institutions. Specifically, the FDIC seeks to minimize to the extent practicable the burdens which a proposed regulation or policy imposes on the banking industry and consumers.

Another critical component of our rulemaking process is to provide the public the opportunity to participate in notice and comment rulemaking under the Administrative Procedure Act. When proposing a new rule, the FDIC provides the public with a notice of proposed rulemaking and the opportunity to submit comments, including comments on the potential effect on consumers. The FDIC carefully considers all comments submitted

[3] http://www.fdic.gov/regulations/laws/rules/5000-400.html#fdic5000developmentar

in response to the proposed rule, and weighs potential costs against the potential benefits based on available information before issuing the final rule. The FDIC also publishes on its website all comments received. Throughout the notice and comment rulemaking process, the FDIC is committed to ensuring that its regulations achieve legislative goals.

To ensure that the FDIC's regulations and written statements of policy are current, effective, and efficient, and continue to meet the principles set forth in this Policy, the FDIC periodically undertakes a review of each regulation and statement of policy. Sometimes, this review is done in conjunction with a change to a regulation or policy statement triggered by a change in the law. In addition, under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and in conjunction with the other agencies of the Federal Financial Institutions Examination Council, the FDIC conducts a comprehensive review of its regulations, at least once every ten years, to identify any outdated, unnecessary, or unduly burdensome regulatory requirements imposed on financial institutions. The FDIC also may initiate a targeted review in a specific area based on changes in the markets or observations at bank examinations, for example.

The regulatory approach followed by the FDIC is intended to implement the statutes enacted by Congress. Rather than prohibiting financial products or services, the FDIC seeks to ensure that they are offered to consumers fairly, and are consistent with safe and sound banking practices.

Community Bank Issues

As the primary federal regulator for the majority of smaller institutions, the FDIC is keenly aware of the challenges facing community banks. The FDIC has tailored its supervisory approach to consider the size, complexity, and risk profile of the institutions it oversees. For example, large institutions (those with $10 billion or more in total assets) are generally subject to continuous supervision (targeted reviews throughout the year), while smaller banks are examined periodically (every 12 to 18 months) based on their size and condition. Additionally, the frequency of our examinations of compliance with the Community Reinvestment Act can be extended for smaller, well-managed institutions. Moreover, in Financial Institution Letters issued to the industry to explain regulations and guidance, the FDIC includes a Statement of Applicability to institutions with less than $1 billion in total assets.

The FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 as part of our broader review of community banking challenges, with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent, while maintaining safe and sound banking practices. Based on the review, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision through the use of web-based tools, regional meetings and outreach. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct

communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. The FDIC is continuing its review of examination and rulemaking processes, and continues to explore new initiatives to provide technical assistance to community banks.

In addition, the FDIC and our fellow banking regulators have been receptive to issues identified by community banks during the rulemaking process. For example, the regulators addressed several issues in the capital rulemaking that were raised by community banks during the comment period. Also, the compliance requirements of the Volcker Rule are designed to avoid placing needless requirements on banks that do not engage in the activities covered by the Rule, such as most community banks.

Finally, the FDIC has taken regulatory action that directly benefitted community banks. In accordance with the Dodd-Frank Act, the FDIC redefined the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. As Congress intended, the change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions. Aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change. The Dodd-Frank Act also made permanent the increase in the deposit insurance coverage limit to $250,000, a provision generally viewed by community banks as helping them attract deposits.

Conclusion

Thank you for the opportunity to testify on the recent regulatory activity of the FDIC. The condition of the banking industry continues to improve from the recent crisis. The FDIC continues to work to reduce the risk of a future crisis and to improve the regulatory tools available if one should occur. At the same time, the FDIC continues to tailor its supervisory approaches to take into account the size and complexity of the institutions it supervises. I would be glad to respond to your questions.

April 8, 2014

Statement for the Record

On behalf of the

American Bankers Association

before the

Financial Services Committee

of the

United States House of Representatives

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April 8, 2014

Chairman Hensarling, Ranking Member Waters, and members of the Committee, ABA appreciates the opportunity to submit for the record comments regarding bank regulation. The ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

New rules and regulations implemented in recent years have fundamentally altered the way banks do business and meet the needs of their customers. While too much risk may have been taken on prior to the financial crisis, recent efforts have sought to eliminate all conceivable risks from the banking system. Taking on risks, however, is fundamental to the business of banking. Banks take a risk by lending and providing payment services to the business that wants to expand and create jobs; they take a risk by making a personal loan to the individual that wants to invest in education; and banks take a risk on the family that wants to buy a home.

Today, banks are being forced to channel enormous resources to comply with regulations and manage the ***regulatory*** risks that come along with them, rather than using those resources for their customers and communities. Banks have already faced 7,605 pages of final rules from the Dodd-Frank Act alone with an additional 5,737 pages of proposed rules. This is an enormous challenge for any bank, but is particularly problematic for community banks which typically have fewer than 40 employees.

Ultimately, the layering on of rule after rule (all of which are highly prescriptive and detailed), combined with comprehensive guidance and supervisory pronouncements that are imposed as if they had the force of law, ends up restricting credit to communities and often limiting who can

access that credit. Less credit means less economic growth, fewer jobs, and lower income for workers.

What is needed is a new approach that acknowledges the important role banks play in fueling our economy and fosters an atmosphere that encourages banks to employ credit in the most effective way possible.

The sad fact is that over the course of the last decade 1,500 community banks have disappeared. This is why hearings about the impact of excessive regulation are so important. It is an opportunity to challenge regulators to take action to stop the rapid decline in the number of community banks and to assure we have a healthy and vibrant banking sector. While changing the consolidation trends through more efficient and focused regulation and supervision may take many years to accomplish, there are actions regulators can take today to address some of the unintended consequences that are emerging from recent regulatory decisions.

For example, Congress was instrumental in encouraging changes in the regulatory treatment of Trust Preferred Securities in Collateralized Debt Obligations (TruPS CDOs) in the original rule implementing the Volcker Rule. Without that change, hundreds of thousands of dollars in losses would have had to be written off in weeks—losses that would have been totally unnecessary. There still remain dislocations from that final rule related to Collateralized Loan Obligations (CLOs), which are packages of loans made to some of our country's largest and most important businesses. By disallowing most of these under the Volcker Rule and forcing divestiture, banks face the prospect of fire-sale transactions that hurts their business and helps non-bank firms that would gladly snatch up bargains at the expense of banks. Going forward, changes can be made to how CLOs are packaged to satisfy the Volcker Rule, but that is no reason to change the rules to punish banks for investments they made in the past. We thank the members of this Committee for your recent actions to address this matter.

A second change that could be made by regulators today relates to capital treatment of mortgage servicing assets. Basel rules have increased significantly the amount of capital that must be held against these assets, it is forcing banks of all sizes to sell these assets to non-banking firms. These sales are already occurring. It makes no sense to penalize banks that service mortgages of their customers. Many banks are not able to take the long-term risk of holding mortgages on their books, but they do want to maintain the relationship with the customer and service their loan. This relationship-building should be encouraged by regulators, not discouraged. The ABA strongly

supports H.R. 4042, legislation introduced by Rep. Blaine Luetkemeyer (R-MO) and Rep. Ed Perlmutter (D-CO) to delay the implementation of Basel rules impacting MSA's until the impact of the new rules can be studied and better alternatives explored.

Another action that can be taken immediately by regulators is to change the dividend treatment for Subchapter S banks so that these banks can make distributions to at least cover the tax bill. Shareholders in a Sub S bank must pay taxes on earnings whether those earnings are distributed or not. Because of the financial crisis, some of these banks had little or no earnings and were under dividend restrictions (which are now even more onerous under Basel conservation buffers). Now that they are returning to profitability, the dividend restrictions prohibit distributions, yet the tax liability remains. This means that not only did the shareholders forego dividends through the financial crisis, but now they must dig into their own pocket to pay the taxes now that the institution is returning to health. This would not be the case of a C-corp, as the taxes are always paid before any dividends could be distributed. While we understand the goal of the dividend restrictions is to channel earnings back into the bank, the tax payment that must be made by Sub S shareholders ends up discouraging capital investment in these banks to begin with—just the opposite of what the regulators want. The action that is needed is simple: allow distributions to cover at least the tax liability. This would make the treatment identical to that of C-corps.

The time to address these issues is now before it becomes impossible to reverse the negative impacts. We thank the Committee for seeking legislative solutions to force changes, but are hopeful action to correct the problems will be made by the regulators without changing the law. It is imperative that banking agencies recognize that the biggest risk that reform imposes is the risk of fewer banking services and the resulting lower economic growth. If banks cannot meet the credit needs of their customers our economy will never reach its full potential.

In addition to the key changes mentioned above that could be implemented in a very short period of time, the remainder of this statement provides ABA's views on many important regulatory changes of particularly interest to the committee. The key points we make are that:

- **New mortgage rules will reduce credit availability;**
- **Bank examinations and supervision should add value;**
- **CFPB's remittance rule is hurting, not helping, bank customers**

- **Tax-favored credit unions and the farm credit system GSE are hurting community-based lenders; and**
- **Operation choke point should be stopped.**

This statement will cover each of these in turn. The ABA staff stands ready to answer any questions on these specific topics as well as provide details on many others that threaten the very survival of many of our finest banks.

New Mortgage Rules Will Reduce Credit Availability

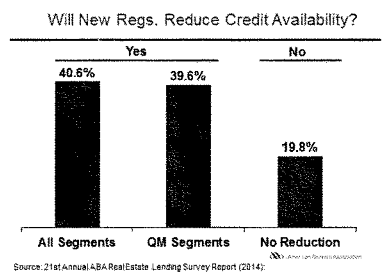
The CFPB's new mortgage rules are fundamentally changing all aspects of the mortgage business—from loan origination to loan servicing. The rules establish new lending and servicing standards for all industry participants. In many ways, these new rules codify many of the conservative lending and high-quality servicing practices that banks have already put into place. However, the new rules are extraordinarily complicated, create strict criteria that borrowers must meet to qualify for loans, and add non-trivial legal risks for loans outside the narrow QM definitions. Thus, many creditworthy borrowers—who may have qualified for loans previously—may be hard pressed to find loans.

Of particular and far reaching concern is the implementation of the Ability to Repay/Qualified Mortgage rule by the CFPB and the impact of that rule on certain loan products and in certain already underserved areas. [1]

These unintended consequences which act to limit credit to some borrowers are being exacerbated by the ongoing and extensive amendments. Frequent amendments and guidance changes create problems for implementation, adding costs which ultimately are paid by borrowers. Banks have been working to comply with the new requirements, but the volume and complexity of the rules has created uncertainty that banks are still working to address.

[1] Dodd/Frank mandates that loans must have a term of not less than five years to meet ability to repay requirements, essentially eliminating short term balloon loans. Such loans have traditionally been a valuable resource for smaller dollar borrowers in rural areas where secondary market mortgage credit is not readily available. Although the CFPB has provided additional time to study the impact of QM/ATR in rural areas, the new rules are already having a deleterious impact on credit availability in some areas.

The limits on credit availability will be felt keenly by those borrowers who are unable to obtain a loan, but may also be felt by the broader economy. While these rules would be harmful during any part of the economic cycle, they are particularly ill-timed now as the housing market is starting to improve. A further delay in the housing recovery would be felt by all Americans, both in the market value of their homes and the impact of housing on the broader economy.



In fact, borrowers and lenders alike are already beginning to feel the impact of all these new regulations. For example, according to ABA's Twenty First Annual Real Estate Lending Survey, which was just released, **33 percent of respondents indicated that they plan to reduce their mortgage lending to only the QM segment of the market.** Moreover, 29 percent of respondents indicated that they would make non-QM loans, but would restrict non-QM loans to targeted segments of the market. Of those who plan to make non-QM loans, 95 percent indicated that they plan to hold those loans in portfolio. That response is not surprising given that there are very few private label secondary market options available and that the federal secondary market (Fannie, Freddie, FHA) all require loans to meet QM. While 38 percent of respondents indicated that the new rules had caused their bank to rethink their commitment to mortgage lending, a full 66 percent indicated that they expect the rules to have a moderate negative impact on credit availability. Forty percent of respondents indicated that they expected a reduction in credit availability across all mortgage segments.

According to a recent report from Ellie Mae, the average FICO score for a conventional mortgage is 755, and borrowers with FICO scores below 620 accounted for less than 1 percent of loans. ***These incredibly high thresholds make it clear that mortgage credit is increasingly moving out of the reach of many borrowers as a direct result of new regulations.***

A particular concern stemming from the unintended consequences of the new rules relates to issues of fair lending. To be very clear: all bankers have a strong stake in ensuring the lending process is fair and not discriminatory. Banks' lending processes ensure that credit reaches all qualified borrowers across the economy, providing the best foundation for growth. However, the

new mortgage rules can work against this goal and lead to restricting credit availability for the very people that need it most.

For example, because of the narrow definition of a qualified mortgage (QM) and the liability risks of non-QM loans, loans will be made to only the best qualified borrowers who meet stringent debt to income standards. In practice, this also likely means that less affluent communities may not be given the support they need to thrive. These rules may leave many communities underserved in the mortgage space. Such a result is not because these banks have any discriminatory practices in place, but rather that the nature of the rules is changing who qualifies for credit.

This raises serious concerns that even a bank making only QM loans might be accused of fair lending violations. On October 22, 2013, the CFPB and the federal banking agencies stated that they "do not anticipate that a creditor's decision to offer only Qualified Mortgages would, absent other factors, elevate a supervised institution's fair lending risk." While statements like this provide some level of comfort to banks, ABA will closely monitor how these statements intersect with a February 15, 2013, final rule issued by HUD that explicitly allows private or governmental plaintiffs to challenge housing or mortgage lending practices that have a "disparate impact" on protected classes of individuals. HUD's rule means that lawsuits can be brought against lenders even if their lending practices are facially neutral and non-discriminatory, and even where there is no direct evidence that the practice was motivated by a discriminatory intent. Ultimately, this means that banks must be more careful when making loans to creditworthy borrowers. Banks may be forced to turn down good borrowers, simply to ensure that their loan portfolios meet certain criteria.

Regulators can alleviate this constriction of credit by taking two simple actions. First, the CFPB can deem any balloon loan held in a bank's portfolio to be compliant with the Ability to Repay standards. It stands to reason that if a bank is willing to make a loan, and hold it on its books, that bank expects that it will be repaid. No further test of ability to repay is needed, as long as the loan meets safety and soundness standards.

Second, the CFPB can use its regulatory discretion to provide lenders with an ability to "cure" a loan which fails to meet the standards of QM. One of the driving factors which inhibiting lending is the liability that comes if a loan is not deemed QM. Lenders are forced to lend only to the "best of the best" in order to avoid the possibility that a loan might fail the QM test. If a right to cure for minor errors, such as a miscalculation of the complex points and fees test used to determine QM eligibility, was provided to lenders, they would be more willing to loan to a broader category of

customers who otherwise might be denied credit for fear of imposing additional liability on the lender if the loan fails the QM test.

Bank Exams and Supervision Should Add Value

The supervisory process should assure risk is identified and managed prudently, bank officials and directors are aware of and understand risk, and sufficient capital and reserves are available to absorb losses. In the aftermath of the financial crisis, the pendulum of bank examination has swung to the extreme. Overbroad, complicated restrictions supplant prudent oversight. Inconsistent examinations hinder lending, increase costs, and create procedural roadblocks that undermine the development of new products and services to bank customers.

While the regulators have made improvements—many in response to Congressional pressure brought about with the introduction of the Financial Institutions Examination Accountability Act (H.R. 1553)—more can be done. For example, Congress could provide immediate relief by creating a balanced and transparent approach to bank examinations and establishing a way for banks to appeal those examination decisions without fear of retaliation.

The banking agencies should move towards customized examinations that consider the nature of a bank's business model, charter type, and perhaps most important, bank management's success at managing credits, including a borrower's character, prior repayment history and strength of personal guarantees. Regulators' traditional focus on a bank's asset size is misplaced. In today's complex banking environment, an array of factors have a far greater impact on a banks' ability to serve its customers—as well as its likelihood to get in trouble—than asset size.

In this regard, examiners should give credit to well-run banks that know their customers and local communities, and have far more experience in identifying which borrowers are creditworthy and which are not, than examiners themselves, especially if examiners are new to a region. One-size-fits-all judgments about such standards as to whether and how much to reserve against loans, especially when driven solely by numerical analysis, effectively take away bankers' autonomy and the value of their judgment in contributing to the best allocation of capital to enhance growth.

Banks, like other private enterprises, should be allowed to run their businesses as they see fit, provided they have sufficient capital and reserves to absorb losses and have demonstrated record of

good management. Auditors consider the myriad of differences among their clients when making a determination of performance; bank examinations should not be any different.

Although no single piece of legislation could remedy all concerns about the current supervisory environment, the following recommendations will significantly improve the examination process. The provisions below include the major elements of the Financial Institutions Examination Accountability Act (H.R.1553), which ABA strongly supported in the 112th Congress and includes the Consumer Financial Protection Bureau (Bureau), as the Bureau is actively engaged in bank examinations.

1. **Timely Exam Reports:** Require regulators (including the Bureau) to provide banks with more timely examination reports and more information about the facts upon which the agency relied in making examination decisions.
2. **Consistent Treatment:** Provide more clarity and consistency regarding how the regulatory agencies and their examiners treat loans with respect to nonaccrual, appraisal, classification, and capital issues.
3. **Examination Ombudsman:** Create a new, independent inter-agency Examination Ombudsman within the Federal Financial Institutions Examination Council (FFIEC) to ensure the consistency and quality of all examinations. First, this would offer an avenue of accountability to assure that the examination process is applied in a manner appropriate to the charter, business model, and size and scale of each bank's operations, rather than in a one-size-fits-all way. An examination needs an effective avenue for accountability because uncorrected examination error can interfere with the ability of banks to provide services, cutting off customer access to credit, raising costs, and reducing product availability. The Ombudsman should have clear authority to take corrective action to remedy examination errors. Second, the Ombudsman can conduct confidential outreach to gauge community bank views of agency performance. This protected communication can encourage candid reviews against which an agency can measure whether actions to address community bank concerns are actually achieving their intent.
4. **Expedited Appeals:** Provide an expedited process for banks to appeal examination decisions without fear of reprisals.
5. **No Retaliation:** Specifically prohibit regulatory agencies from retaliating against banks, including their service providers and any institution-affiliated party as defined in the

Federal Deposit Insurance Act. An agency cannot delay or deny action that would benefit a bank or institution-affiliated party that is appealing an agency decision.

CFPB's Remittance Rule is Hurting, Not Helping, Bank Customers

Initial evidence suggests that the October 2013 Consumer Financial Protection Bureau's (CFPB) rule has had the unintended consequence of forcing many banks to either raise the prices for these services or stop offering them altogether.

While providing increased transparency for consumers is a priority for banks, the additional disclosures associated with this come with a cost. ***Banks should not be expected to provide information they do not have and cannot get.*** Ultimately, a rule designed to protect consumers should not end up costing them more or limiting their options.

Remittance transfers are an important service offered by banks, allowing consumers to make international transfers to friends, family and businesses in other countries. The World Bank estimates that $440 billion in remittance payments were made in 2010, of which $325 billion went to developing countries. These payments are a critical service that consumers rely on to safely and expediently deliver money to their families that depend on them. Moreover, both senders and recipients of remittance payments have a higher propensity to hold a bank account. As such, remittance payments promote access to financial services and financial education.

The CFPB's rule, authorized by Section 1073 of the Dodd-Frank Act, requires banks to provide additional disclosures regarding the fees and adds protections for consumers when they send international transfers. Among other changes, the provisions of the Dodd-Frank Act require the disclosure of the exact amount that a recipient of a wire transfer will receive. Unfortunately, the rule and its provisions did not take into account the complexity of the international banking system and the breadth of the international transfer system. As a result, CFPB has already had to amend and revise the rule to avoid becoming a barrier to certain transfers.

After the Remittance Rule went into effect on October 28, 2013, ABA surveyed fifty banks in order to gauge the rule's impact on banks. Although the entirety of burdens have yet to be determined, many banks have already made the decision to either increase prices and fees in order to cover added compliance costs or to stop providing remittance transfer services altogether. In fact, of the banks surveyed who are currently subject to the rule, 42 percent plan on increasing fees

to cover additional compliance costs while 18 percent plan to stop offering remittance services altogether.

Even when banks continue offering these services, they will restrict where transfers are sent due to the challenges of complying with the mandatory disclosures when the information is not readily obtainable. In other cases, banks are limiting transfers to well-known and established customers to control potential risks. Other banks are choosing to wait before making any decision to end the service or raise fees, but they anticipate that over the next few months compliance costs will force a decision either way.

Similarly, banks who are exempt from the rule because they are under the threshold of 100 remittance transfers a year expect to either raise fees or discontinue the service if they surpass the threshold in the future. In fact, 50 percent of these banks indicated that they would raise fees if they exceed the threshold with a further 8 percent planning on discontinuing the service altogether if they become subject to the rule. This ends up hurting customers who have relied on the bank to make these important payments.

Tax-favored Credit Unions and the Farm Credit System GSE are Hurting Community-based Lenders

Not only do banks today face incredible pressure from new regulations placed on them, but they must also compete with a number of tax-favored entities such as credit unions and the Farm Credit System (FCS). This unlevel playing field puts extreme pressure on small banks, contributing heavily to industry consolidation.

Today, the public does not differentiate banks from credit unions; so why should the tax and regulatory oversight be different? Congress never intended credit unions to be merely tax-free banks. But that is what they have become while not paying a dime in federal income taxes. It is shocking how credit unions have leveraged their taxpayer subsidy to aggressively grow—becoming a $1 trillion industry. In fact, there are now 209 credit unions with more than $1 billion in assets—a significant increase from the 13 only twenty years ago. And as the credit union industry expands, it does so at the expense of all taxpayers.

Extraordinary growth of the Farm Credit System—now a $247 billion behemoth—creates enormous and unfair competitive pressures on taxpaying banks serving rural communities. The FCS

posted ***$4.3 billion in profits*** in 2012 and paid only $222 million in takes for an effective tax rate of barely 5 percent.

For both credit unions and the FCS, the evidence shows the tax-subsidy has largely been misdirected. Credit unions are using their tax exemption to subsidize wealthy individuals and commercial real estate developers instead of focusing on the financial needs of low- and moderate-income individuals—the very individuals Congress envisioned them serving. California-based Technology Credit Union ($1.8 billion in assets), for example, offers jumbo mortgage loans up to $8 million to their affluent members—all subsidized by taxpayers.

Eighty-three percent of FCS loans went to large borrowers, not small farmer. Moreover, loans are often ***non***-agriculture related, such as the $725 million loan made by CoBank to Verizon to finance the purchase of a European cell phone company. Congress should have oversight hearings and ensure that the Farm Credit System pays its fair share of taxes, and restore its focus to serve small farmers and ranchers.

Many credit unions today have determined to mirror everything a bank does and the National Credit Union Administration (NCUA) seems anxious to accommodate those desires rather than protecting the expansion of the credit union subsidy paid by taxpayers and ensuring it is appropriately directed. If credit unions want to act like banks, there should be a simple, fair and workable path to ***convert*** to a mutual bank charter—a process that NCUA has thwarted at every turn. The process must be straightforward and predictable, without NCUA's patronizing proposition that credit union members do not understand their ownership rights and interests in a conversion—and if they did, would never vote for a conversion. This is NCUA protecting its turf and not protecting taxpayers.

Rather than be a cheerleader for credit unions, NCUA should assure that underwriting standards match those required by banking regulators and should disclose information about expenditures, such as executive compensation and charitable donations. Most tax-exempt organizations, including universities and hospitals, must disclose the compensation of senior officials to the Internal Revenue Service in the Form 990—a form that has become an important tool for determining the transparency and accountability of tax-exempt organizations. By publicly disclosing this information, the Form 990 fosters good corporate governance as it attempts to ensure that the tax expenditure is being appropriately employed.

Federal credit unions should be required to file Form 990 information return or its equivalent just like state-chartered credit unions and most other tax-exempt institutions. ***These are actions that can and should be done by NCUA today***. Expanding the public's opportunities to review executive salaries would promote improved corporate governance and greater credit union accountability. It would inform Congress, taxpayers, and credit union members about whether this valuable tax subsidy is going towards the credit union mission or is subsidizing credit union management.

Operation Choke Point Should Be Stopped

Banks are in the business of providing financial services for law-abiding customers, and they share a common goal with law enforcement of maintaining the integrity of the payments system.

Banks devote major personnel and technological resources every year to fight financial crime. These expenditures enable banks to meet the unfunded Congressional mandates of the Bank Secrecy Act and its related laws. Depository institutions filed close to one million suspicious activity reports in the past year alone, covering such subjects as mortgage fraud, identity theft, counterfeit debit and credit cards, and wire transfer fraud. These suspicious activity reports help federal and local law enforcement identify and develop cases to pursue in the fight against financial crime.

Unfortunately, regulatory pile-on has converted the straightforward four pillar Bank Secrecy Act/Anti Money Laundering statutory mandate built around the policy that banks should identify customers, keep records and report suspicious activities into a compliance exercise with over 350 pages of examination procedures, additional pages of regulatory guidance and expanding supervisory expectations that is turning the Bank Secrecy Act into the government directed bank surveillance Act. This regulatory drift has been further leveraged by the banking agencies to impose additional layers of regulatory and reputation risk on banks performing normal banking services on businesses of all types engaged in interstate commerce.

For one, the FDIC expects our members to differentiate across the patchwork of legal requirements applied to the businesses they bank and to ensure that their customers and even their customers' customers are operating in compliance with all applicable state and federal laws. The scope of customers the FDIC has classified as "high risk," is extensive and impossible for banks to

keep tabs on. This is an impossible and statutorily unfounded standard, extending far beyond the fundamental framework and division of responsibility between banks and law enforcement to pursue a public/private partnership to protect the legitimacy of the payment system.

On top of this regulatory groundwork, the Department of Justice has initiated Operation Choke Point that starts with the premise that businesses of any type cannot effectively operate without access to banking services. It then leverages that premise by pressuring banks to shut down accounts of merchants targeted by the Department of Justice without formal enforcement action or even charges having been brought against these merchants. There often is no court order or other appropriate legal enforcement proceeding that banks are being asked to implement. Rather the program targets the bank for facilitating a customer's business conduct that the bank cannot demonstrate is operating in compliance with all applicable federal and state law--compounding the overreach initiated by the banking agencies.

Taken together the banking agencies and the Department of Justice are ratcheting up regulatory and reputation risk to effectuate a choking off of services to businesses—including money service businesses and non-bank lenders— placing on banks the burden to differentiate between proper or improper conduct and based on those risk-based judgments to close accounts or face vicarious liability for the activity of its customers.

Our members report that agency assertions of expansive regulatory requirements, examiner second-guessing of suspicious activity monitoring and law enforcement's overbroad theories of legal liability for delivering basic banking services create increasing operating expense and compliance costs that deter banks from serving a range of businesses that are legally licensed but still have risky profiles. This regulatory environment undermines our industry's efforts to support our community's businesses and grow our national economy.

Our concern with Operation Choke Point is not its goal of fighting financial fraud, but rather the policy premise upon which the initiative is based, the faulty legal foundation it asserts, and the manner in which it is applied. We strongly urge a recalibration of the regulatory standards that vindicates the pro-partnership policies that lie at the core of bank BSA/AML responsibilities. We believe that we can combat financial fraud more effectively working together with our agencies and law enforcement than we can by making our industry surrogate targets for the real wrongdoers.

Conclusion

Recent years have seen an unprecedented number of new rules piled onto the banking industry. Although they are all well-intentioned, each one of these prescriptive and complicated new rules carries unintended consequences. The cumulative effect of rule after rule after rule piled on to banks, and the regulatory risk that accompanies it, limits their ability to meet the needs of their customers. Every dollar put towards compliance—often for overlapping rules—is a dollar that cannot be lent. Ultimately, this restricts access to credit for communities across the country. This is the credit that consumers rely on to achieve their personal goals and businesses rely on to expand and create jobs. Without access to credit there is no way the economy can get back up to speed and consistently create jobs and increase income for workers. We must take action to ensure that the unintended consequences of new regulations do not restrict credit access and hinder job growth.

Testimony to the U.S. House Financial Services Committee

Submitted by ACA International

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ACA™
INTERNATIONAL
The Association of Cred
and Collection Profession

509 2nd St NE
Washington, D.C. 20002

(202) 547-2670
www.acainternational.org

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About ACA International (www.acainternational.org)
With offices in Washington, D.C. and Minneapolis, ACA International is the largest trade association representing the consumer credit and debt collection industry. ACA member organizations employ more than 350,000 men and women as third-party debt collectors, debt buyers, collection attorneys, creditors and industry service providers. ACA has 40 state-level units representing the 50 states and one unit representing more than 60 countries abroad.

I. Executive Summary

America's credit-based economy relies on the recovery of rightfully owed consumer debt. Without the efforts of third-party debt collectors, companies can't pay their bills and keep people employed; the price for goods and services increases; the availability of affordable credit decreases; and governments are forced to cut services and/or raise taxes to cover shortfalls.

It is no secret that many consumers would rather not be told they owe money. The collection process, by its nature, often produces an emotionally charged response when consumers are contacted about a debt. The work of America's third-party debt collectors is not an easy job, nor is it perfect.

Sensationalism by media, consumer groups and others appears to advocate that personal responsibility to pay a debt should be easily wiped away and gives the faulty impression that most consumers are being contacted by debt collectors. In fact, only about 10 percent of the adult population in America actually ever is contacted by a debt collector due to an unpaid debt. This leaves 90 percent of the adult population who pay their bills.

More than 350,000 men and women employed by ACA International member companies take their important responsibility to balance consumer protection and the lawful recovery of rightfully owed consumer debt very seriously. As their trade association, we are committed to providing training, compliance and advocacy.

Since the Consumer Financial Protection Bureau's inception in 2010, ACA has sought a collaborative professional relationship. Our mission has been to help the CFPB understand the complexities of the debt collection marketplace and help our members understand the actions of their new regulator. We have regularly reached out to the CFPB and have appreciated the extent to which the CFPB staff members have been willing to work with us. It is our intent to continue this practice in the future.

Despite the positive aspects of ACA's relationship with the CFPB, there are some areas for concern:

- **The CFPB's approach seems to be overly burdensome.** Through its use of Civil Investigative Demands (CID) and other enforcement tools, CFPB is undertaking overly broad investigations and data collection efforts that take significant time and resources of businesses. In doing so, the CFPB is expanding its organizational intelligence at the expense of the businesses it is charged with regulating.

- **The CFPB's complaint process seems more intent on creating headlines than resolving policy issues.** Analysis of the CFPB's consumer complaint database for debt collection and related processes identifies systemic reliance by the CFPB on raw complaint data, uncolored by appropriate and significant context. The result is headlines, not balanced public policy actions that would be helpful to ACA members and consumers alike.

- **The CFPB's approach to debt collection rulemaking seems overly broad and the agency seems to be circumventing important processes.** Upcoming new rules for debt collection may create a "one-size fits all" approach that ignores the uniqueness of the fragmented industry. It raises concern that unintended consequences and excessive compliance expenses will further drive companies out of business. Further, the CFPB seems to be exerting its non-rulemaking authority in ways that create *de facto* rules – thereby forcing businesses to follow these rules while circumventing the spirit and intent of the defined rulemaking process. We implore the CFPB to be clear and direct in regard to its rulemaking to prevent unintended consequences that could not only negatively affect small businesses but also the nation's economy for years to come.

- **The debt collection industry needs help from the CFPB to stem the tide of exploitive FDCPA lawsuits.** ACA International has repeatedly asked for the CFPB's help with the challenges of frivolous Fair Debt Collection Practices Act (FDCPA) legal actions brought against debt collectors by the consumer bar. We've asked for maximum clarity to ensure industry members can comply and be provided with model language, disclosures and "safe harbors" to stop exploitation by consumer attorneys.

ACA International hopes to encourage the CFPB to better tailor its approach and more thoughtfully work with the industry to reform America's consumer debt collection system. Together, we believe we can achieve this goal and find the proper balance between all important consumer protections and the ability to recover rightfully owed consumer debts for the public and private sectors.

II. Collection Industry Background

About the United States Consumer Debt Collection Industry

Consumer debt collection is an essential financial function that maintains America's credit-based economy.

Creditors that provide products, goods and services rely on the recovery of consumer debts to ensure their business survival. These funds are used to pay employee salaries and benefits; are used for rent, operational expenses and supplies; ensures low cost credit remains available to consumers; and prevents price increases for products, goods and services.

In addition to the private sector, federal, state and local governments across the country rely on the recovery of debts owed by taxpayers including student loans, taxes, fees, court fines, and utility bills. When not recovered, these entities rely on tax increases and cuts in services to cover budget shortfalls.

Consumer debt collection is a complex and often misunderstood industry. There are three primary facets of consumer debt collection that are co-dependent in many respects, yet very different in others. However, from the perspective of consumers and policymakers they are often lumped together under the general umbrella of debt collection.

- **First-Party / Creditor** - Organizations in the private and public sectors that provide a product, good or service undertake efforts to collect consumer debts on their own behalf (e.g., retailers, telecommunications, credit card companies, banks, local retailers, hospitals and health care providers, utilities, cable companies). This collection activity is conducted by employees of the organization or their proxy. The activities of creditors undertaking first-party collections generally are not governed by the FDCPA.
- **Third-Party Collectors** - Organizations that help with revenue cycle coordination, accounts receivables management, and the recovery of rightfully owed consumer debts for creditors in the private and public sectors. While ownership of the debt remains with the creditor, third-party collectors seek the repayment of the debt. They typically work for an agreed upon commission based on what is recovered. When their work is done, the amount recovered is returned to the creditor and the third party collector is entitled to a commission based upon actual recoveries. Third-party debt collectors are subject to the FDCPA and roughly 20 other federal statutes; CFPB, FCC and FTC provide federal regulatory oversight; state laws requiring licensure; state consumer protection statutes; state regulatory and enforcement oversight; and restrictions placed by their creditor clients to ensure compliance and maximum customer service. Based on SIC codes, there are approximately 4,000 third-party collection agencies in the U.S.
- **Debt Buyer** - Organizations that purchase debts from creditors and seek to recover them. In this scenario, the debt buyer becomes the creditor as they now own the debt. Debt buyers may seek to contract with third-party debt collectors, much like an original creditor does, to initiate recovery efforts. Debt buyers may also choose other legal means to recover a rightfully owed debt, such as litigation. Like third-party debt collectors, debt buyers are subject to the federal FDCPA. According to the CFPB, there are approximately 500 debt buying companies in the U.S.

Economic Impact of Third-Party Debt Collection in the United States

The U.S. economy is built on the premise that those who provide credit, goods and services have the expectation of being repaid. Recovery of consumer debt by third-party debt collectors on behalf of America's public, private and non-profit sectors has significant effects on our nation's economic health. For instance, recovering consumer debts helps with the following:

- Promotes organizational survival (e.g., pay bills, payroll, operational expenses, etc.)
- Prevents layoffs
- Keeps credit, goods and services available at an affordable price
- Reduces the need for tax increases to cover government budget shortfalls

Third-party debt collectors do more than just recover consumer debt. They are businesses that are engaged in their local communities as valued civic leaders, employers, volunteers, philanthropists and taxpayers. To measure the various impacts of third-party debt collection on the national and state economies, ACA International commissioned global advisory firms PricewaterhouseCoopers and Ernst & Young to undertake this research from both a national and state specific perspective.

This research looked beyond the traditional data on debt recoveries to provide a snapshot of the other important benefits that third-party debt collectors provide the national, state and local economies: jobs and payroll provided; taxes paid; volunteer hours in local communities and philanthropy.

Analysis is based on data provided by ACA International members and is aggregated to ensure confidentiality of participants. Additional information is available at www.acainternational.org/impact.

Returning Assets	2010	2007	2005
Gross amount recovered:	$54.8 billion	$51.9 billion	$51.4 billion
Collector commissions:	$10.3 billion	$11.5 billion	$12.1 billion
Net amount recovered:	$44.6 billion	$40.4 billion	$39.3 billion
Providing Jobs	**2010**	**2007**	**2005**
Direct Jobs	148,272	155,000	150,000
Direct Payroll	$5 billion	$6 billion	$5 billion
Indirect & Direct Jobs	302,000		
Indirect & Direct Payroll	$10 billion		
Paying Taxes	**2010**		
State / local taxes paid	$509 million		
Federal taxes paid	$495 million		
Total State / local	$ 1 billion		
Total Federal tax impact	$970 million		
Giving Back	**2010**		
Contributions to charity	$85.2 million		
Employee volunteer hours	652,000		

The Collection Industry and Financial Literacy

ACA International members support helping consumers and military service members better understand their rights if contacted by a debt collector. In 2009, www.askdoctordebt.org was created to provide valuable information. Since its launch, more than 200,000 consumers have visited www.askdoctordebt.org and ACA has answered more than 1,000 questions submitted by site visitors.

Laws and Regulations

The activities associated with collecting consumer debt are among one of the most regulated in the U.S. Third-party debt collection agencies and debt buyers are subject to many rigorous federal, state and local laws and regulations governing their actions. In all, 88 percent of collection agencies have 49 employees or fewer while 59 percent of collection agencies have nine or fewer employees.

The patchwork and conflicting aspect of the many federal and state laws, regulations and regulators governing the collection of consumer debt creates inconsistency. It makes compliance difficult and consumers who receive conflicting and inconsistent information are often not having their expectations met.

In all, there are many federal laws and regulations that impact third-party collection agencies.

- **Fair Debt Collection Practices Act of 1978 (FDCPA)**
  The activities of third-party debt collectors are governed by the FDCPA. In addition, many states have adopted laws with requirements that go beyond the FDCPA. These laws have created a high degree of variability from state to state. Further, cities such as New York, Buffalo and Chicago have adopted local ordinances applicable to the activities of third-party debt collectors, with more likely to follow.

- **Fair Credit Reporting Act of 1970 (FCRA)**
  Certain activities of third-party debt collectors are governed by the FCRA. It was passed by Congress to ensure accuracy and fairness in credit reporting.

- **Telephone Consumer Protection Act of 1991 (TCPA)**
  The TCPA prohibits a debt collector from contacting a consumer on a mobile device through use of an automatic telephone dialing system without prior consent. While the intent of the TCPA was to prevent unwanted solicitations from telemarketers, it is applied in a manner that covers non-solicitation; informational calls that are normal business communications expected by consumers. Many businesses, including collection agencies, choose to use autodialing technology to efficiently and effectively reach consumers to communicate. Automatic dialing technologies help assure compliance by avoiding human errors in dialing and by systematically assuring that calls are placed to consumers with reasonable frequency, at convenient times of day, and help to limit the number of phone calls to a consumer in any given period of time. Unfortunately, plaintiff's attorneys are exploiting unclear areas in this law to file individual and class-action lawsuits against businesses, including third-party collection agencies. This practice leaves it to courts to interpret the TCPA, potentially in conflicting ways, at great expense and with no benefit to consumers.

  In 1991, when the TCPA was passed, mobile phones were not widely used and expensive for consumers. As technology has evolved, mobile phones and other mobile communication devices are not only more affordable but they have all but replaced land lines as consumers' preferred means of communication. An increasing number of consumers live in homes that no longer have landline telephones at all, preferring instead the convenience and mobility of a cellular phone (or similar). The TCPA has had the unintended consequence of not being technology neutral and is outdated, making it ripe for reform.
  - A call from a debt collector is not a solicitation; it is informational with a specific business purpose.
  - The definition of prior consent remains a widely debated topic with little clarity.
  - Automatic telephone dialing systems used by debt collectors do not call consumers at random. They only call telephone numbers of people with the purpose of recovering a rightfully owed debt.
  - It is permissible for a debt collector to manually call a consumer's mobile device – they just cannot use today's efficient automatic dialing technology to do so.

- In addition to those above, other federal laws and regulations regulating third-party debt collectors include:
  - The Higher Education Act of 1971, Pub. L. No. 89-329
  - The Electronic Fund Transfer Act, 12 U.S.C. §§ 222 et seq.
  - The Fair Credit Billing Act, 15 U.S.C. §§ 1666 et seq.
  - The Federal Bankruptcy Code, 11 U.S.C. §§ 101 et seq.
  - The Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 et seq.
  - The Health Insurance Portability and Accountability Act, 42 U.S.C. § 1320d-2 et seq.
  - The Right to Financial Privacy Act, 12 U.S.C. §§ 3401 et seq.
  - Truth in Lending Act, 15 U.S.C. §§ 1601 et seq.
  - Regulation E, 12 C.F.R. § 205.1 et seq.
  - Regulation J, 12 C.F.R. § 210.1 et seq.
  - Regulation M, 12 C.F.R. §§ 213 et seq.
  - Regulation Z, 12 C.F.R. § 226 et seq.

- There is significant oversight of third-party debt collectors at the federal, state and local levels:
  - Consumer Financial Protection (CFPB) – FDCPA plus unfair, deceptive and abusive acts or practices
  - Federal Trade Commission (FTC) – FDCPA
  - Federal Communications Commission (FCC) – TCPA
  - Congress
  - 50 state attorneys general, licensing bodies and financial departments
  - 50 state legislatures
  - U.S. judicial system
  - City councils, county boards of directors and local regulatory bodies

Client Expectations are Often More Restrictive than Laws

In addition to federal, state and local laws and regulation, ACA members are also subject to contract requirements created by their clients that are increasingly stricter than federal or state law and regulation. These agreements, which vary greatly in detail, set forth standards for operations and conduct that collection agencies must follow. This may include the number of contacts per consumer, recording and monitoring of telephone calls, documentation requirements and parameters for settlement of accounts.

III. Impacts of the CFPB on Third-Party Debt Collection

ACA has sought a mutually respectful and collaborative relationship with the CFPB since the agency began operating in 2010. ACA efforts have included, but are not limited to, the following:

- Educating CFPB leaders on the complexity of the debt collection industry.
- Monitoring the CFPB's actions and responding as appropriate on behalf of ACA members.
- Inviting CFPB leaders to speak at our conferences and interact with industry members.
- Participating in industry relevant hearings, work groups and panels.
- Preparing ACA members for supervision, rulemaking, enforcement and complaint resolution.

By its very nature, the creation of a robust and powerful regulator with the ability to promulgate rules is likely to have a significant impact on the businesses it oversees. Third-party debt collection is no different. Of primary concern is that the CFPB's impact on those it regulates should not be so overly burdensome as to impede the ability of debt collectors to undertake the important job of recovering rightfully owed consumer debt.

The CFPB began "officially" supervising the third-party debt collection industry in January 2013. ACA and its members outline the following perspective based on a wide array of experiences with the CFPB.

Examinations and Investigations

As the CFPB's oversight of the third-party debt collection industry increases, it has had an unintended consequence of imposing significant financial burden on companies. Nationally, 88 percent of collection agencies have 49 employees or fewer while 59 percent of collection agencies have nine or fewer employees. Many of these are multi-generational family businesses.

Although it is clear that compliance is an important priority, marshaling resources to respond to broad investigative demands, data collection, and reacting to meritless consumer complaints requires significant time and resources.[1]

ACA members have expressed concern over the broad nature of Civil Investigative Demands (CID). There is also concern that the CFPB may be using this investigative tool as a vehicle to inappropriately gather proprietary data about the marketplace that it wouldn't otherwise be able to obtain.

In undertaking these expansive and expensive activities, the CFPB seems to be using its leverage broadly to gain data and business intelligence while shifting the expenses on to the shoulders of companies that can ill afford the additional burden. In some instances, the cost of complying with a CID has topped $500,000 and threatens the livelihood of small to mid-sized business. These investigations have an undefined duration and have lasted in excess of two years in some cases, and there is a concerning lack of clarity by the CFPB during the process. A lack of transparency frustrates and confuses the companies that are subject to this investigative technique. These companies are not given timely responses by the CFPB as to whether wrongdoing has actually occurred. Moreover, many of the staff used by the CFPB to conduct these explorations seems to not have had much, if any, practical experience with collection agency businesses.

Many of the companies who are being burdened by the CFPB's actions are placed at a competitive disadvantage because it forces companies to shift resources to fulfill the CFPB's requests instead of serving the needs of clients. Additionally, this scrutiny needlessly implies wrongdoing and scares away customers and potential customers.

After considerable pressure, the CFPB has capitulated and taken the wise step of ending the counterproductive practice of bringing enforcement lawyers to supervisory examinations, which created an adversarial and intimidating climate during site visits, and inhibited open communication with the supervised company. A review by the CFPB Ombudsman also recommended areas for improvement in CFPB examinations by encouraging more transparency and better clarity around the examination lifecycle.

ACA believes that CFPB would be well served to better understand the day-to-day operations of collection agencies to facilitate a more focused, less intrusive and less resource intensive approach to finding the information it needs. Communication between the CFPB and the businesses it is investigating or supervising needs improvement.

[1] See examples in Appendix A and B

Consumer Complaints

ACA and its members take consumer complaints very seriously. Despite that ACA member agencies have created ethics and compliance contacts to address consumer complaints, consumers are being pushed to turn to the CFPB as the first point of contact for relief. While in fact only around 10 percent of adults have delinquent debts, an unparalleled level of emphasis is being placed on consumer complaints without adequately addressing the fact that approximately 90 percent of consumers pay their bills on time and do not receive contact from creditors or debt collectors.

Unfortunately, consumer complaint data has become a tool that regulators exploit to generate media headlines rather than using consumer complaints as an opportunity to identify and resolve underlying public policy concerns. Until July 2013, the FTC was primarily responsible for receiving consumer complaints and reporting on the FDCPA to Congress. Consistently and to no avail, ACA outlined its concerns about the FTC's data and use of its findings to inaccurately paint the behavior of companies tasked with the collection of consumer debts with broad brush, including:

- Complaints were never verified as valid nor were they investigated to determine if actual wrongdoing ever occurred. Further, the practice of including consumer inquiries as complaints in the published complaint data, even if they are not actual complaints, seems to be a questionable practice aimed solely at increasing the overall total.
- Data was not publicly available without a Freedom of Information Act request, which can only occur after the FTC released its findings to Congress and the media. This has always forced the collection industry to defend itself from data it has not had a fair chance to examine in a timely manner.
- Examinations of data received following FOIA requests, by ACA and other industry interests, identified troubling inaccuracies and duplicate reporting. In many cases, consumer inquiries were wrongly categorized as complaints.
- Consumers filing complaints with the FTC were added to a tally without an effort to connect them to the collection agency to resolve their issue.

In July, 2013, the CFPB took over responsibility for consumer complaints regarding third-party debt collection. The process implemented by the CFPB is consistent with ACA's position that communication is the cornerstone for effectively helping consumers resolve their issues. When given the opportunity, third-party debt collectors have shown great propensity for helping consumers find solutions. According to the Better Business Bureau, in 2012, collection agencies resolved 86 percent of the consumer complaints received compared to the national average of 77 percent for all other industries combined.

According to our analysis[2] of the CFPB's Annual Report to Congress on consumer complaint regarding debt collection, it is sensational but short on substance. The findings are presented in a way that generates media headlines and inflames public sensitivities but completely ignores important data such as the number of complaints that are truly inquiries; many complaints are based upon a misunderstanding of the debt collection process; and those complaints that are resolved to consumers' satisfaction. Further, the CFPB's report does not seem to set the groundwork for meaningful discussion toward identifying or resolving the glaring public policy challenges that our industry has repeatedly brought to their attention.

While the CFPB's report is based on data that is not publicly available, ACA's analysis of the publicly available data identifies the following:

- The CFPB's definition of a complaint is subjective and broad.[3] While a consumer may not like something (such as being contacted about a debt or receiving multiple calls) it does not mean that the collector actually did anything wrong. Neither the CFPB nor the FTC investigates these complaints as to whether a complaint actually violates the law. Painting the collection of consumer debts with a broad brush and then inferring that this is a result of bad behavior paints an inaccurate picture of an extremely necessary, yet sometimes uncomfortable, activity. ACA advocates that the CFPB adopt a more meaningful definition of what constitutes a complaint that is limited to consumer allegations of wrongful conduct and does not include the amorphous concept of general consumer dissatisfaction outside of wrongful conduct.
- Some factors that contribute to consumers being contacted about a debt they may not owe are the mobile nature of society and the unwillingness of most consumers to communicate with creditors or debt

[2] See ACA's analysis of CFPB complaints in Appendix C of this document.
[3] See complaint examples from ACA members in Appendix D of this document.

collectors. Further, federal law prohibits disclosure of specific information about a debt until a consumer's identity has been verified. Hearing from a collection agency that they don't know and never had interaction with can often be confusing.

- A closer look at concerns over the frequency of debt collection calls omits discussion of a very significant "catch-22," which is a significant underlying factor prompting debt collectors to call more often instead of leaving voice mail messages. Under the FDCPA a debt collector can not divulge the existence of a consumer debt a third-party. There is currently no safe harbor language for leaving a voice mail that assures a debt collector can comply with the FDCPA. ACA is calling on the CFPB for the creation of safe harbor language to allow collectors to leave voice mail messages that comply with FDCPA.
- The limited amount of information provided about consumers to debt collectors in the CFPB complaint process makes accurate identification and a timely response difficult.
- Consumers often are unclear about what activities or policies that specifically relates to creditors, credit reporting agencies, and activities undertaken by debt collectors.
- The CFPB and FTC have left out of their reports two very important facts: 1) When looking closely at the complaint data it is clear that the majority of complaints are attributed to a small number of collection agencies that, not surprisingly, make the vast majority of consumer contacts (most collection agencies only have a small number of complaints); and 2) Debt collector contacts are a driving force for complaints. Each year, debt collectors make more than 1 billion contacts to consumers and, when compared against the complaint statistics (to which we believe are inflated), the number of complaints equals less than one percent of the number of contacts.

Further, the CFPB failed to mention that 96 percent of complaints are responded to in a timely manner and 94 percent of complaints were "closed" in some manner.

ACA has recommended the following changes to the CFPB regarding complaints:

- Clearly identify first-party collections from third-party collections to ensure accuracy in complaint reporting and avoid the potential for double counting.
- Maintain context by resisting the temptation to use a broad-brush to paint debt collectors negatively or make assumptions about the behavior of an entire industry solely on top line complaint volume data.
- Provide more consumer detail to debt collectors who are the subject of a complaint to increase the likelihood of more easily identifying the information needed to resolve the consumer's complaint.
- Adopt definition of a complaint that is limited to consumer allegations of wrongful conduct and does not include the amorphous concept of general consumer dissatisfaction outside of wrongful conduct.
- Offer more meaningful content to consumers to help them understand the credit extension, credit reporting and debt collection activities to set expectations in a useful and unbiased manner.
- Change the letter templates it created for consumers to use when working with debt collectors to ensure consumers understand their rights under current law. At least one of these letters gives consumers inaccurate information, which leads to additional complaints against debt collectors.

Rulemaking

The CFPB has created a Larger Market Participant rule related to debt collections in order to identify the scope of businesses that would be automatically subject to the CFPB's supervisory authority (although the CFPB has indicated that its broad authority allows it to examine all participants).

Additionally, the CFPB issued an Advanced Notice of Proposed Rulemaking (ANPR) to signal its intent to create new rules targeting debt collection. The ANPR featured 162 multiple part questions that were wide-ranging in scope. Based on thoughtful comments and data received from its diverse membership, in addition to answering the questions posed in the ANPR, ACA's submission centered around four important priorities:

- The CFPB should recognize that the debt collection market is extremely varied in the types of debt being collected and the nature and size of the nation's debt collectors encompasses a broad scope.
- The CFPB should appropriately tailor requirements to the specific circumstances for which any perceived problem exists when imposing additional regulatory requirements on industry participants.
- The CFPB should address outdated, unnecessary or unduly burdensome requirements under the FDCPA.

- The CFPB should strive for maximum clarity in any forthcoming regulations to ensure the regulatory compliance obligations of industry participants are certain, and to develop model language, disclosures, forms and examples of compliant behavior, whenever practicable, in order to create appropriate "safe harbors" from regulatory enforcement and private civil litigation that seeks to exploit legal and regulatory uncertainty to the detriment of debt collectors.

While the fact that rulemaking by itself is not a surprise, if the CFPB doesn't appropriately recognize that a one-size-fits-all approach is not viable, the impact will be the following:

- The uniqueness of the complex debt collection market will not have been considered and, therefore, will create unintended consequences that could have been avoided with a more thoughtful approach. The residual impact will take significant time and resources to fix. An approach more tailored to the industry seems to be a more responsible approach.
- Excessive costs[4] to comply with the new rules will force many small companies out of business, which comprise the vast majority of the third-party debt collection industry.
- Uncertainty over what the rule will ultimately include has slowed the growth of an industry that the Bureau of Labor Statistics has forecasted will grow in the future.

Moreover, the CFPB seems content to leverage enforcement actions (and resulting consent decrees), bulletins, speeches and press releases to create *de facto* rules that force third-party collectors to follow these policy positions. In doing so, the CFPB is circumventing the spirit and intent of the defined rulemaking process, by exerting its authority in this manner.

ACA has asked the CFPB in its rulemaking to address outdated, unnecessary or unduly burdensome legal requirements in the FDCPA, which would modernize the collection of consumer debt.

Provide Help with Egregious Plaintiff Litigation

In discussions and comments filed with the CFPB, ACA International has reiterated the challenges associated with the huge spike in legal actions generated by the consumer 's against law abiding debt collectors over frivolous FDCPA, FCRA, and TCPA actions.

The FDCPA is directly under the purview of the CFPB and ACA has sought its assistance in providing clarity that brings relief to this exploitation. According to data from a data aggregator, WebRecon, in 2007, there were 4,329 FDCPA lawsuits filed against third-party debt collection firms. In 2011, this number topped 12,000 and in 2013 totaled 10,320. As of February 2014, nearly 1,500 FDCPA lawsuits had already been filed by consumer attorneys.

In particular, under the FDCPA, a debt collector cannot divulge the existence of a debt to any third party. There is currently no safe harbor language for leaving a voice mail that assures a debt collector can comply with the FDCPA. The result of this very significant "catch-22," is that an increasing number of debt collectors choose to call more frequently in hope of reaching a consumer instead of leaving voice mail messages that can result in a lawsuit asserting third party disclosure.

ACA has asked the CFPB to do two important things:

1. Provide safe harbor language to allow debt collectors to leave voice mail messages that comply with FDCPA. We believe this will help facilitate timelier, more meaningful communications between consumers and debt collectors while reducing call frequency.
2. In its forthcoming rules, provide maximum clarity to ensure industry members can comply and be provided with model language, disclosures and "safe harbors" to minimize exploitation through private civil action by consumer attorneys.

It is important to note that while the consumer's bar has positioned its efforts as helping consumers, the reality is that no consumers profit and no improvement occurs in the consumer's experience with debt collection. In strict liability statutes, such as FDCPA, lawyers are using the statutory damages and the attorney's fees provision to enrich themselves instead of providing real monetary relief to consumers. This is exacerbated by the continued use of strong arm tactics to coerce settlement agreements. As previously cited, ACA members are primarily small businesses and the cost of defending themselves from legal action adds a significant financial burden that threatens their livelihood.

[4] See examples in Appendix A and B

IV. Conclusion

The intent of ACA International's testimony is to share member experiences with the House Financial Services Committee as requested. We have appreciated the many positive aspects of our relationship with the CFPB and plan to continue on this path in the future.

However, ACA members have provided significant feedback on their experiences with the CFPB and the challenges it is creating for their businesses. An industry comprised primarily of small to mid-sized businesses, ACA members are profoundly impacted by public policies at federal, state and local levels. We are concerned about their continued survival.

While we firmly believe in the importance of protecting consumer rights, there is an essential need to provide balance in allowing these debts to be recovered. Plain and simple, as the backbone of America's credit based economy, the private and public sectors rely on the efforts of the third-party debt collection industry.

ACA International members, as consumers themselves, follow ethical and lawful collection practices, and believe in the personal responsibility of consumers to pay rightfully owed debts. The notion of consumer indebtedness isn't new. Since the 1980s, the use of consumer credit rose steadily reaching its peak in 2008, when the nation's economy entered into the biggest economic downturn since the Great Depression. When the use of credit has increased, there is a corresponding increase in the level of default and delinquency.

More than 350,000 men and women go to work each day in the debt collection industry. They are skilled professionals with an important job to responsibly, respectfully and lawfully communicate with American consumers to resolve outstanding accounts. It is a difficult and demanding profession. But, it is absolutely essential if private and public sector organizations want to stay in business and consumers want affordable products, goods and services.

ACA International hopes to encourage the CFPB to step back to better tailor its approach and more thoughtfully work with the industry to reform America's consumer debt collection system. Together, we believe we can achieve this goal and find the proper balance between all important consumer protections and the ability to recover rightfully owed consumer debts for the public and private sectors.

V. Appendix

Appendix A

February 13, 2014

The Honorable Jeb Hensarling
United States House of Representatives
Chair, Financial Services Committee
2129 Rayburn HOB
Washington, DC 20515

Dear Chairman Hensarling and members of the House Financial Services Committee:

As a small business owner under the direct purview of the Consumer Financial Protection Bureau, thank you for the opportunity to briefly share my perspective with the House Financial Services Committee on how our business will be impacted by its new regulator.

Credit Clearing House of America (CCHA) is a family-owned company that employs 29 people in Louisville, KY. Our focus is the respectful, responsible and lawful recovery of consumer debt on behalf of creditor clients. We are under the CFPB's regulatory umbrella as a non-bank financial services company.

My concerns revolve around small collection agencies and their creditor clients. According to data from ACA International (www.acainternational.org/impact), 88% of collection agencies employ 49 or fewer employees and 59% employ nine or fewer employees. We work on behalf of large, medium and small creditor clients, ranging from Fortune 500s to Main Street businesses, which rely on our efforts to recover consumer debt that they are rightfully owed. The future of our credit based economy and the ability of our clients to survive is of paramount importance to the national, state and local economies.

In reviewing its recent Advanced Notice of Proposed Rulemaking for debt collection, the CFPB seems to be seeking sweeping changes without regard to business size or other defining nuances. I have significant concerns about the onerous nature of one-size-fits-all rules that are likely to be proposed by the CFPB and whether my small business can survive in the long-term. While large to mid-size agencies may be able to more easily adapt to the CFPB's new rules, smaller businesses like mine may unfortunately be "too small to succeed" due to excessive operational burdens and costs associated with compliance.

As the son of a bill collector, I literally grew up in the credit and collection industry and have over the years been fortunate enough to meet four generations of people who run or manage collection agencies throughout the country. Our company has had a Better Business Bureau rating of A+ for as long as I can remember. The people I know in the industry also have the utmost respect for treating people fairly. I am not sure what problem the CFPB is trying to solve for our industry by pursuing more regulations.

Small collection agencies and many of the creditors we work for have limited staff, revenues, technology and resources. Many of these small or micro-businesses operate on a shoestring budget. From our perspective, the ability to be nimble and less expensive than larger businesses is an important competitive advantage. Conversely, overly burdensome and expensive regulations will force us as well as many of our small creditor clients to divert precious resources that will hinder our ability to compete.

Based on my personal experience growing up in our family owned business which was founded by my father 62 years ago and now as our small businesses owner and the feedback I've received from our smaller members in my role on the ACA International Board of Directors, a broad-brush approach doesn't work. I fear for the future of our company and our two sons who have graduated from college and returned to work at the small company their grandfather started in 1951. If our company is too small to comply with these new regulations and the companies we work for are too small too, where does that leave all of our employees? We fear it will result in many collection agencies and creditor clients becoming casualties of these rules and likely forced out of business. That's bad for America, bad for our states and bad for local communities.

Thank you for taking time to consider my concerns.

Sincerely,

Mike

Michael T. Gardner, Sr.
President
Credit Clearing House of America, Inc.
305 W. Market Street
Louisville, KY 40202

Appendix B

The following documentation was provided to ACA by a Large Market Participant collection agency member.

This information highlights the recurring increased costs to this agency's operations based on the CFPB's regulatory oversight since 2012. This ACA member employs 450-500 men and women in multiple locations across the country. Their clients are in the credit card/bank card, auto loan, student loan, utility and telecom industries.

While some of these increased costs are driven directly by CFPB oversight of collection agencies, much of the costs are attributed to requirements from their bank clients based on CFPB directives.

Much of these costs are associated with recreating and duplicating process to supply redundant information back to clients. While the business stored this data itself, clients are now requesting to store the same information in the event it is requested by the CFPB. It has created significant expense for this business including prompting the hiring of additional staff to manage these processes.

Activity	Annual Cost	Details
Revenue Loss		
• Lower liquidation	$2,000,000	Revenue loss due to providing new disclosures
• Interest reversal on charged off debt	$3,000,000	Revenue loss on client interest rates
• Loss of free market; issuers unable to switch providers	$3,000,000	
Increased Legal Review		
• Legal cost increase in review of all transactions	$213,812	
• Insurance increase	$126,418	
Technology Investment Increase		
• Programming to accommodate constantly changing regulation	$300,000	
• Call analytics	$375,000	Require disclosures
• Data storage increase	$269,875	Saving call recordings
Direct Labor Cost Increases		
• HR and recruitment	$185,245	Labor increase since CFPB
• Compliance Department	$349,332	Labor increase since CFPB
• Call monitoring	$249,419	Labor increase since CFPB
• File documentation and file transfers	$243,719	Labor increase since CFPB
• Additional training and reporting	$185,697	Labor increase since CFPB
• Focus of top management on CFPB	$500,000	Meetings with clients and CFPB
• 300% increase in audits by clients	$196,878	Labor increase since CFPB
• Copies of all letters	$75,000	Labor and materials costs since CFPB
Total per year	***$11,270,395***	
Total for 2012 and 2013 combined	***$22,540,790***	

TAKING A CLOSER LOOK:

Analysis of the Consumer Financial Protection Bureau's Debt Collection Complaints

March 6, 2014

ACA™ INTERNATIONAL
The Association of Credit and Collection Professionals

Research

www.acainternational.org

Table of Contents:

About ACA International (www.acainternational.org)
With offices in Washington, D.C. and Minneapolis, ACA International is the largest trade association representing the consumer credit and debt collection industry. Our nearly 5,000 member organizations employ more than 350,000 men and women as third-party debt collectors, debt buyers, collection attorneys, creditors and industry service providers. ACA has 41 state-level units representing the 50 states and one unit representing more than 60 countries abroad. The recovery of consumer debt is very important to America's credit-based economy and, according to an economic impact study by Ernst & Young, third-party collection agencies recovered $55 billion on behalf of creditor clients in 2010.

I. Executive Summary

Introduction
ACA International's Research Department created the following analysis of the Consumer Financial Protection Bureau's (CFPB) complaint database for debt collection. We undertook this study to gain insight into consumer complaint issues and, in particular, to learn more about the information and to use it for the collection of debts. Our goals with this analysis are to improve communication between debt collectors and customers, and to mitigate the number of complaints made by customers.

This report is based on a sample of 14,328 complaints received by the CFPB between July 2013 and February 2014. In addition, this report uses data from the Quarterly Report on Household Debt and Credit from the Federal Reserve Bank of New York to show the average balance of accounts in third-party debt collections (Q1 2003-Q4 2013).

Since the 1980s, the use of consumer credit rose steadily reaching its peak in 2008, when the United States economy entered into the biggest economic downturn since the Great Depression. Consumer spending habits created massive growth in the level of delinquent/defaulted debts owed to businesses and government. This includes both discretionary and non-discretionary spending.

America's credit-based economy relies on the recovery of rightfully owed consumer debt. As the nation's economy faltered, it triggered wide-spread efforts by public and private sector creditors, third-party debt collectors working on behalf of creditor clients, and companies that have purchased written-off consumer debts to seek to recoup what was possible. Without these efforts, companies can't pay their bills and keep people employed; the price for goods and services increases; the availability of affordable credit decreases; and governments are forced to cut services and/or raise taxes to cover shortfalls.

A heavier reliance on credit coupled with economic turmoil has resulted in more than one billion consumer contacts per year. Conversely, complaints by consumers contacted about a delinquent or defaulted debt also increased. Consumers don't want to be told they owe money and it often produces an emotionally charged response when contacted.

ACA International members take complaints against debt collectors very seriously and have pledged to work with key stakeholders including the CFPB, Federal Trade Commission (FTC), Better Business Bureau, state lawmakers, state regulators and state attorneys general to best balance consumer protections and the ability to recovery a rightfully owed debt.

Key Findings
The CFPB makes publicly available data that includes company name, consumer ZIP code, product, sub-product, issue, complaint submission date, and response timeliness. Comparison of key findings from ACA's previous report on CFPB complaints in November 2013 finds little to no changes among general trends in February 2014.

In addition, ACA supplemented analysis of the CFPB's data with the Quarterly Report on Household Debt and Credit of the Federal Reserve Bank of New York to provide a snapshot of the average balance of accounts in third-party debt collection:

- The average balance of accounts in third-party debt collection increased from $1,458 in the third quarter of 2013 to $1,520 in the fourth quarter of 2013, representing a 4.29% increase.
- The highest number of identifiable complaints was for credit card and medical debts. However, taking into account the category "others" and "not specified" together, 50.41% of the complaints were not associated with a particular debt collection product.

- The most reported consumer concern was being contacted about "a debt they did not believe they owed." In second place was "communication tactics" followed by "disclosure verification of a debt." However, there is no subsequent follow-up on whether these consumer concerns were resolved after communications with creditors or debt collectors. Further, a closer look at the "communications tactics" sub-section identifies the most frequent concern was the frequency of calls. It should be noted that a "catch-22" under the Fair Debt Collections Practices Act (FDCPA) is prompting an increasing number of debt collectors to not leave voicemail and instead make more calls to consumers in the hope of reaching a live person.

- Almost all the complaints received by the CFPB were responded to in a timely fashion. Based on the data, 96% of the complaints were responded to with a timely response.

- Of the 14,328 complaints analyzed, 94% were "closed," "closed with non-monetary relief" or "closed with explanation."

Concerns with CFPB's Complaint Database

- There is a lack of clarity in the data as to whether complaints are against first-party creditors, payday lenders, third-party debt collection companies or others. Aggregating these creates uncertainty about complaints possibly reported more than once, painting an inaccurate portrait of third-party debt collectors.

- The limited amount of information provided about consumers to debt collectors in the CFPB complaint process makes accurate identification and timely response difficult.

- The CFPB's description of a complaint, coupled with the fact that it does not investigate whether any real wrongdoing has occurred or whether it is an inquiry/request for additional information, enables the data to create an inaccurate perception of the extent of wrongful conduct.

- Due to the 60-day lag time from company response to consumer dispute of the company response, coupled with a lack of completeness in the database, an accurate assessment on the number of disputes cannot be made at this time.

Recommendations to the CFPB and Others Regarding Complaints

- Clearly identify first-party collections from third-party collections to ensure accuracy in complaint reporting and avoid the potential for double counting.

- Maintain context by resisting the temptation to use a broad-brush to paint debt collectors negatively or make assumptions about the behavior of an entire industry solely on top line volume data.

- Provide more consumer detail to debt collectors who are the subject of a complaint to increase the likelihood of more easily identifying the information needed to resolve the consumer's complaint.

- Adopt definition of a complaint that is limited to consumer allegations of wrongful conduct and does not include the amorphous concept of general consumer dissatisfaction outside of wrongful conduct.

II. Overview

The purpose of the Report – Analyzing CFPB Consumer Complaint Data
In 2010, the U.S. Congress passed the Dodd-Frank Act that created the CFPB. Among its many responsibilities, the CFPB supervises the third-party debt collection industry and maintains a database of complaints against debt collectors.

In July 2013, the CFPB officially began accepting consumer complaints pertaining to debt collection whereby consumers may register a complaint and have it reviewed/resolved through communications with a debt collector.

ACA International's Research Department has analyzed a total of 14,328 debt collection complaints released by the CFPB, dating from July 2013 to February 2014. Comparison of key findings from ACA's previous report on CFPB complaints in November 2013 finds little to no changes in February 2014. The purpose of this analysis is to better understand the data beyond simply reviewing the total number of complaints.

ACA Members and Complaints
Third-party consumer debt collectors make approximately one billion contacts to consumers per year. ACA members are aware of consumer complaints and want to work seriously with the consumers to resolve their concerns. ACA's Code of Ethics requires each ACA member company to identify a specific contact designated to work with consumers to address complaints against a third-party debt collector. ACA is committed to helping members better understand and comply with federal, state and local laws governing the collection of consumer debt. Moreover, we provide exceptional training to help members prevent complaints from occurring and to meaningfully resolve them if they do.

ACA members realize that consumers most often prefer to share complaints with intermediaries such as the CFPB. However, we welcome the opportunity to work directly with consumers to resolve complaints. Communication is the cornerstone for effective consumer debt collection and, when given the opportunity, ACA members continue to show they can be successful in appropriately resolving consumer complaints. According to the Better Business Bureau, in 2012, collection agencies resolved 86% of the consumer complaints received compared to the national average of 77% for all other industries combined.

ACA and the CFPB
ACA has sought a mutually respectful and collaborative relationship with the CFPB. ACA efforts have included, but are not limited to, the following:

- Educating CFPB leaders on the complexity of the debt collection industry.
- Monitoring the CFPB's actions and responding as appropriate on behalf of ACA members.
- Inviting CFPB leaders to speak at our conferences and interact with industry members.
- Participating in industry relevant hearings, work groups and panels.
- Preparing ACA Members for supervision, rulemaking, enforcement and complaint resolution.

The Recovery of Consumer Debt is Vital to Federal, State and Local Economies

America's credit-based economy relies on the recovery of rightfully owed consumer debt. As the nation's economy faltered, it triggered wide-spread efforts by public and private sector creditors, third-party debt collectors working on behalf of creditor clients, and companies that have purchased written-off consumer debts to seek to recoup what was possible. Without these efforts, companies can't pay their bills and keep people employed; the price for goods and services increases; the availability of affordable credit decreases; and governments are forced to cut services and/or raise taxes to cover shortfalls.

ACA regularly conducts research to assess the actual impact third-party debt collection has on the national and state economies. Our most recent data, conducted by Ernst & Young in 2011, can be found at www.acainternational.org/impact.

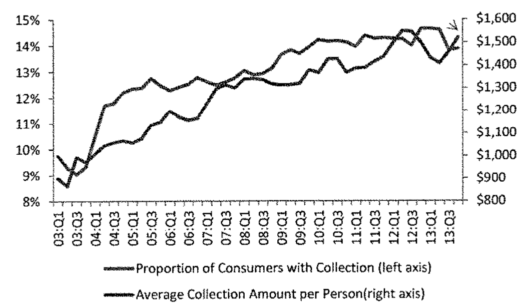
III. Data Analysis

This section provides an analysis of the data gleaned from the 14,328 consumer complaints pertaining to debt collection that have been submitted to the CFPB between July 2013 and February 2014. Additionally, we have used the available data from the Quarterly Report on Household Debt and Credit provided by the Federal Reserve Bank of New York.

Proportion of Consumers with Collection and Average Collection Amount per Person

The graph below shows the proportion of consumers with collection at a national level between 2003 and 2013, represented in the blue line and read from the left axis. The purple line is read from the right axis and represents the Average Collection Amount per Person.

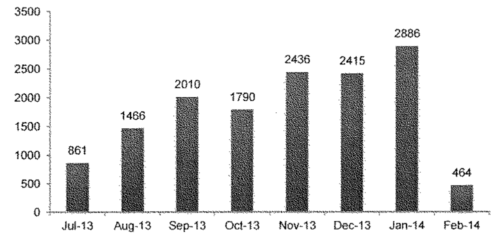
The proportion of consumers in collection has increased over the past 10 years, remaining at a relatively constant rate of 14% over the past four years. The average collection amount per person increased 4.29% from $ 1,458 in the third quarter of 2013 to $ 1,520 in the fourth quarter of 2013.



Data Source: Federal Reserve Bank New York

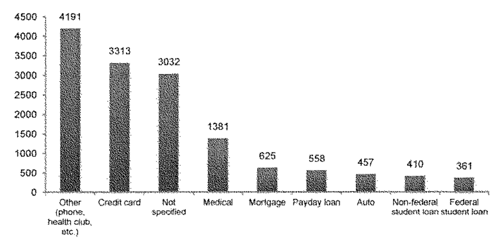
Amount of Consumer Complaints Received by Month

Based on the data below, consumer complaints per month are trending upward. The increase from September 2013 of 2,010 complaints to December 2013 of 2,415 complaints represents an increase of 20.15%. The number of complaints in January 2014 did increase to 2,886. Data for February only reflects complaints through 17 days of the month.



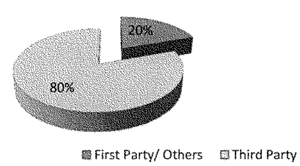
Number of Complaints by Sub-Products

Taking a closer look at the sub-products, the highest number of identifiable complaints was for credit cards with 3,313, followed by medical products with 1,381 complaints. A total of 4,191 complaints were not directly associated with a certain debt collection product (e.g., phone, health club, etc.) and 3,032 complaints were not specified.



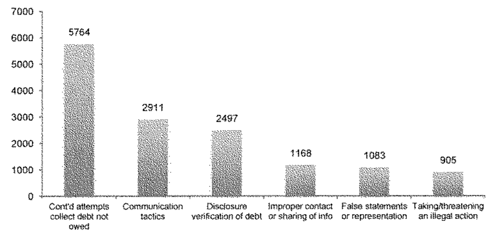
Percentage of Complaints Coming from Third-Party and Creditors

ACA reviewed the list of companies and was able to identify the number of companies that were not third party-debt collectors, including a number of financial institutions and banks. Of the total of 14,328 complaints, approximately 2,822 or 20% were made against companies conducting first-party collections (credit card companies, pay day lenders, or other direct creditors).



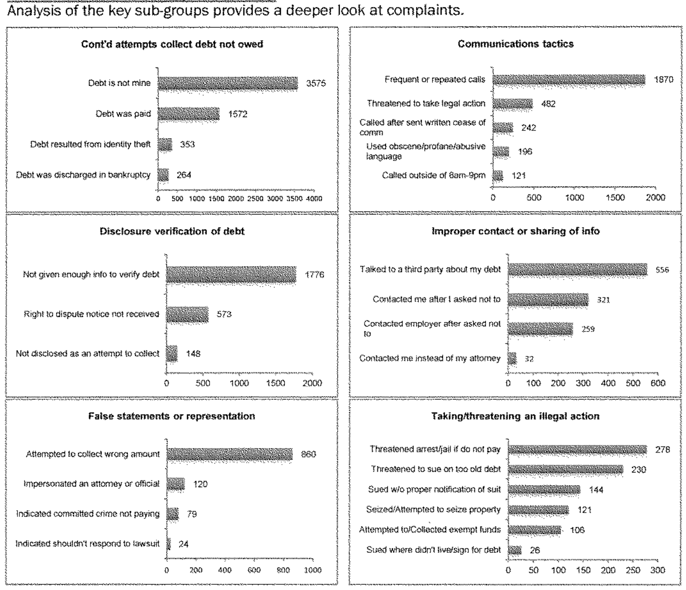
Number of Complaints by Key Issues

A total of 5,764 complaints pertained to "a debt the consumers believe they did not owe." "Communications tactics" followed at 2,911. The third most reported complaint is "disclosure verifications" of a debt totaling 2,497. However, there is no follow-up data on how many of these complaints were eventually proven to be accurate by the debt collectors in question.



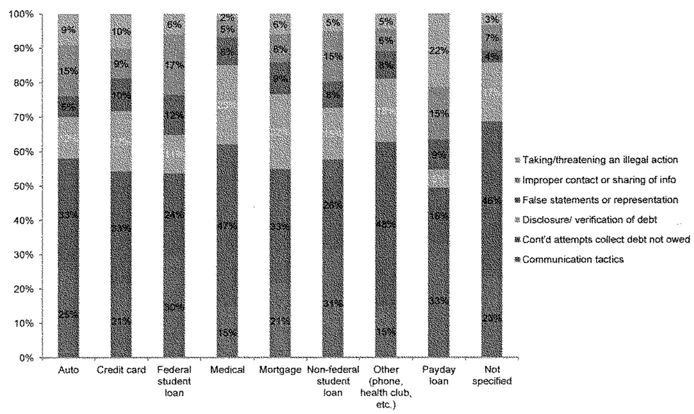
Breakdown of Issues by Sub-Group

Analysis of the key sub-groups provides a deeper look at complaints.



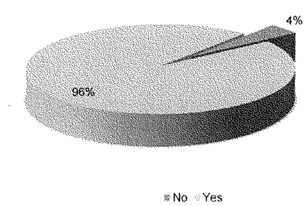
Allocation of Issues by Sub-Group

The graph below shows the allocation of issues by sub-group, demonstrating the percentage of each sub-group to its main issue. It is interesting to observe that 47% of the complaints belonging to medical issues are related to debts that consumers believe they do not owe. In the same way, medical debt has a relatively high rate of complaints related to "disclosure/verification of debt." Student loans have one of the highest rates of complaints related to "communications tactics" and "false statement or representation."



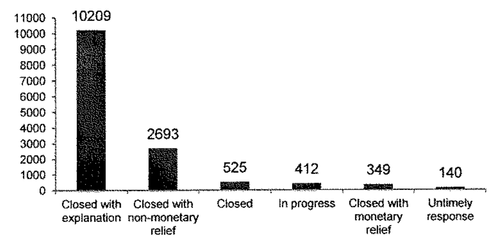
Complaints Received in a Timely Fashion

The vast majority of the complaints were responded to in a timely manner, 96% respond on time, whereas 4% did not respond on time. This shows the commitment of the debt collection industry to comply with the CFPB's established timeline for responding to complaints.



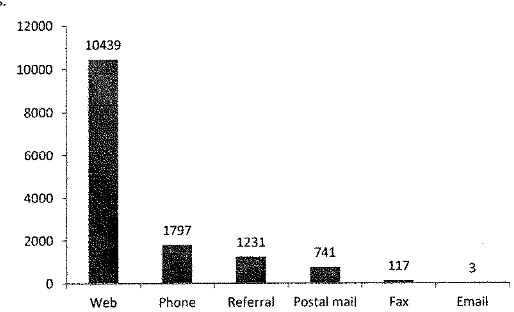
Outcome of the Progress Status of Companies Complaints

In all, 93.71% of complaints were "closed," "closed with non-monetary relief "or "closed with explanation." Of the 14,328 complaints, 10,209 (71%) were closed with an explanation. A total of 2,693 complaints were registered as "closed with non-monetary relief." A total of 349 complaints were listed as "closed with monetary relief."



Complaints by Submitted Channel

It is essential to find out through which channels the consumer complaints were made. Without any doubt the CFPB website, with 10,439 complaints received, represents the most popular submission method by a significant margin. E-mail represents the platform of lowest submission with 3 complaints.



Number of Complaints by State in Comparison to the Total Debt Collected in 2010

Column two shows the number of complaints for each state. Column three shows the percentage of complaints each state represents to the total number of complaints received by the CFPB. Column four shows the amount of total debt collected in 2010, followed in column five by percentage of the total amount of debt collected. Column six shows the difference between the percentage of complaints and the percentage of debt collected in 2010.

State	Complaints	% of Complaints	Total Debt Collected 2010 (in million)[1]	% Debt Collected 2010[2]	Difference
AL	160	1.1%	753.8	1.4%	-0.2%
AK	24	0.2%	74.2	0.1%	0.0%
AR	92	0.7%	2274.2	4.1%	-3.5%
AZ	337	2.4%	435.4	0.8%	1.6%
CA	1910	13.6%	4400.6	8.0%	5.6%
CO	242	1.7%	1160.4	2.1%	-0.4%
CT	111	0.8%	258.3	0.5%	0.3%
DE	59	0.4%	387.7	0.7%	-0.3%
DC	88	0.6%	1.6	0.0%	0.6%
FL	1228	8.8%	2836.3	5.2%	3.6%
GA	580	4.1%	2277.8	4.2%	0.0%
HI	49	0.3%	36.2	0.1%	0.3%
ID	62	0.4%	128.7	0.2%	0.2%
IL	425	3.0%	2658.4	4.8%	-1.8%
IN	204	1.5%	787.5	1.4%	0.0%
IA	68	0.5%	491.7	0.9%	-0.4%
KS	104	0.7%	748.9	1.4%	-0.6%
KY	148	1.1%	668.9	1.2%	-0.2%
LA	178	1.3%	641.9	1.2%	0.1%
ME	31	0.2%	93.2	0.2%	0.1%
MD	360	2.6%	711.9	1.3%	1.3%
MA	223	1.6%	1324.8	2.4%	-0.8%
MI	364	2.6%	736.4	1.3%	1.3%
MN	140	1.0%	1833.8	3.3%	-2.3%
MS	71	0.5%	289.1	0.5%	0.0%
MO	231	1.6%	1300.9	2.4%	-0.7%
MT	39	0.3%	209.5	0.4%	-0.1%
NE	37	0.3%	447.3	0.8%	-0.6%
NV	181	1.3%	643.3	1.2%	0.1%
NH	40	0.3%	402.1	0.7%	-0.4%
NJ	495	3.5%	1219.9	2.2%	1.3%
NM	87	0.6%	65.6	0.1%	0.5%
NY	952	6.8%	5310.4	9.7%	-2.9%
NC	311	2.2%	808.6	1.5%	0.7%
ND	13	0.1%	106.6	0.2%	-0.1%
OH	478	3.4%	2597.9	4.7%	-1.3%
OK	141	1.0%	777.8	1.4%	-0.4%
OR	187	1.3%	486.3	0.9%	0.4%
PA	523	3.7%	2407.8	4.4%	-0.7%
RI	50	0.4%	27.4	0.0%	0.3%
SC	238	1.7%	597.3	1.1%	0.6%
SD	26	0.2%	205.5	0.4%	-0.2%
TN	245	1.7%	1999.9	3.6%	-1.9%
TX	1349	9.6%	5329.2	9.7%	-0.1%
UT	105	0.7%	381.1	0.7%	0.1%
VT	11	0.1%	28	0.1%	0.0%
VA	471	3.4%	1057.4	1.9%	1.4%
WA	310	2.2%	1311.3	2.4%	-0.2%
WV	39	0.3%	355.4	0.6%	-0.4%
WI	176	1.3%	647.1	1.2%	0.1%
WY	27	0.2%	146.5	0.3%	-0.1%

Top 50 Companies Receiving Complaints

According to the data, the top 50 companies by complaint volume, as identified by the CFPB, total 7,900 complaints. Of the top 50, a total of 37 companies are identified as third-party collectors (5,645). Thirteen companies (totaling 2,255 complaints) are considered something other than a traditional debt collector (e.g., credit card, student loan servicers, creditors and pay day lenders).

Their inclusion creates confusion in comparing third-party debt collectors, who are subject to the FDCPA and a myriad of state laws and regulations that creditors do not have to follow. Moreover, it also raises concerns about duplicative listings for complaints on a debt filed with both the creditor and the debt collector seeking to recover the debt on behalf of a client.

IV. ACA Recommendations/Conclusion

ACA International undertook this study to gain insight into consumer complaint issues and, in particular, to learn more about the information and to use it for the collection of debts. The main goal of this analysis is to improve the communication between debt collectors and customers, to mitigate the number of complaints made by customers.

It is important to ensure all possible options to get efficient resolutions that need to be considered for every consumer. Informing consumers about all their options in the debt collection process and the consequences of non-payment should be essential. Third-party debt collectors would benefit from future study and examination of these and other issues relating to debt collection.

Understanding the data and doing a thoughtful analysis of consumer complaints can be a useful tool in determining trends and areas for concern as well as areas for improvement by the industry. ACA pledges to continue working with our members to improve compliance, preventing complaints and resolving them if they occur. ACA desires to help the CFPB improve its complaint database so that collectors, consumers, policymakers, regulators and others have an accurate snapshot.

We offer the following suggestions to the CFPB:

- Clearly identify first-party collections from third-party collections in complaint reporting and avoid the potential for double counting complaints that stem from the same underlying issue.
- Maintain context by resisting the temptation to use a broad-brush to paint debt collectors and make assumptions about the behavior of an entire industry solely on the volume of complaints.
- Provide more detail to debt collectors who are the subject of a complaint to increase the likelihood of more easily identifying the information needed to resolve the consumer's complaint.
- Adopt a definition of complaint that is limited to consumer allegations of wrongful conduct and does not include the concept of general consumer dissatisfaction outside of wrongful conduct.

Appendix D

The following documentation is intended to provide a few examples of consumer complaints reported to the CFPB and sent to ACA member agencies. Our intent in sharing these examples is to illustrate ACA's point that not every correspondence with the CFPB is a complaint. Yet these are recorded as such and then sent to businesses seeking a response. This is skewing the data being shared with Congress and the American public in that it is painting an inaccurate portrait of consumer debt collection.

We believe that debt collectors and consumers should communicate. The examples below reflect the importance of the essential need for this communication so our members can help consumers resolve the issues at hand.

The four examples below are excerpts sent to ACA members from the CFPB's portal. Content of the entire form has been shortened to ensure confidentiality but can be made available upon request. The CFPB's portal URL is www.secure.consumerfinance.gov/apps/instagent/detail/comp

Example 1

Product:	Debt collection: I do not know
Issue:	Disclosure verification of debt: Not given enough info to verify debt
Describe what happened:	Be advised this is note refusal to pay, but a notice that your claim is disputed and validation is requested- Under the Fair Debt Collection Practices Act (FDCPA), I have the right-to request validation of the debt you say owe you. I am requesting proof that I am indeed the party you are asking to pay this debt, and there is some contractual obligation that is binding on me to pay this debt. This is not a request for "verification" or proof of my mailing address, but a request for validation made pursuant to 15 USC 1692g, Sec. 809 (of the FDCPA). I respectfully request that your offices provide me with competent evidence that I have any legal obligation to pay you. At this-time I will also inform you, that if your offices have or continue to report invalidated information to any of the three major credit bureaus (Equifax, Experian, Trans Union), this action might constitute fraud under both federal and state laws. Due to this fact, if any negative mark is found or continues to report on any of my credit reports by your company or the company you represent, I will not hesitate in bringing legal action against you and your client for the following.
Desired resolution:	Please provide the following: Agreement with your client that grants you the authority to collect on this alleged debt. Agreement that bears the signature of the alleged debtor wherein he/she agreed to pay the creditor. Any insurance claims been made by any creditor regarding this account. Any Judgments obtained by any creditor regarding this account. Name and address of alleged creditor. Name on file of alleged debtor- Amount of alleged debt. Data this alleged debt became payable. Date of original charge off or delinquency. Verification that this debt was assigned or sold to collector. Complete accounting of alleged debts. Commission for debt collector if collection efforts are successful.

Example 2

Product:	Student loan: non-federal student loan
Issue:	Problems when you are unable to pay
Describe what happened:	I want hit soon to be covered and paid off by consolidation
Desired resolution:	I think my loan should be paid off

Example 3:

Product:	Debt collection: Credit card
Issue:	Communications tactics: Frequent or repeated calls
Describe what happened:	I recently received a bill from you, a copy of which is attached. I am writing to tell you that am unable to pay the debt. I lost my job from November 2010 and my income comes solely from unemployment from period November 2010 to April 2013 and is now exhausted. I currently have irregular part time jobs in which it is hard for me to meet my daily needs. I do not own a home or any real estate. I do not have money in my bank accounts. My car is still not paid and cannot pay on time. The value of my property does not exceed $4,000.00. As all my income and property are exempt under the laws of Illinois, any attempt to collect this debt will not be successful. I am sorry that I cannot pay the bill, but I hope that you will understand my situation.
Desired resolution:	None given

Example 4

Product:	Debt collection: I do not know
Issue:	Disclosure verification of debt: Not given enough info to verify debt
Describe what happened:	I've checked a copy of my credit report and realized that there was a collection reported from your company, which I was not notified about. I do not reject to provide with the debt amount. However, this is a notice sent pursuant to the Fair Debt Collection Practices Act 1 S USC 1692g Sec 809 (b), that your claim is disputed and a validation is demanded. This is asking for proof regarding the debt that I owe and verifying it. I am requesting you to stop all collection activities including reporting this information on my credit report. I am sure that you are aware of the fact that non-compliance with this request may end up in legal obligations.
Desired resolution:	I am requesting you to stop all collection activities including reporting this information on my credit report.

United States House of Representatives
Committee on Financial Services

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Hearing:

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

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Tuesday, April 8, 2014

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Statement for the Record
by the
American Financial Services Association

About AFSA

Founded in 1916, the American Financial Services Association (AFSA) is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Our 350 members include consumer and commercial finance companies, auto finance and leasing companies, credit card issuers, industrial banks and industry suppliers. Prior to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010, AFSA members were always responsible for adhering to the federal consumer statutes and regulations, but most were exclusively licensed and examined by the states in which they conducted business. Today, as covered persons pursuant to the Dodd-Frank Act, they are subject to the full jurisdiction of the Consumer Financial Protection Bureau (CFPB or Bureau).

Statement of Interest

AFSA represents banks as well as captive finance companies, sales finance companies and retail installment sales finance companies. These consumer finance companies – many of which are small local or regional businesses – are licensed and supervised by state banking agencies or consumer credit authorities. Unlike banks or credit unions, their extensions of credit are funded by placing their own capital at risk, rather than through insured deposits. As a result of the Dodd-Frank Act, consumer finance companies find themselves subject to a new layer of federal supervision and enforcement that is dramatically raising their compliance costs and will impact the availability of consumer credit.

This testimony will review our experience engaging with the CFPB on behalf of the consumer credit industry, as well as several key policy areas where we disagree with the Bureau's approach. This is not an exhaustive list, but rather a selection of issues that are especially current and relevant to the Financial Services Committee's oversight of the CFPB.

*

Our Industry's Engagement with the CFPB

AFSA has met with various CFPB personnel to explain our members' role in the consumer finance industry. To their credit, CFPB staff have asked thoughtful questions and exhibited a genuine desire to learn about our business. Senior agency officials have also agreed to speak to our members at large and small gatherings and have traveled to do so on several occasions. In addition, the Bureau has invited AFSA staff and members to participate in public events it sponsors. We appreciate this ongoing engagement and the opportunity to make our industry's voice heard.

These meetings have sometimes preceded shifts in policy by the Bureau that reflect a more nuanced understanding of the marketplace. For example, the CFPB incorporated some key changes to the mortgage servicing rule that were helpful to our members. The CFPB also made some changes to the regulations implementing the CARD Act, for which AFSA had asked. Additionally, we have been granted longer periods of time to comment on *Federal Register* notices.

Policy Areas where AFSA Disagrees with the CFPB's Approach

However, on several major issues with which we have been engaged with the CFPB, despite having reason on our side, we seem to be getting nowhere. These issues include: (I) the CFPB's crusade against motor vehicle dealer finance income; (II) the CFPB's reluctance to distinguish creditors from third-party debt collectors; (III) the CFPB's insistence that the credit bureaus make the furnisher dispute system needlessly burdensome; and (IV) the CFPB's arbitration study that appears biased toward restricting the use of pre-dispute arbitration and class action waiver provisions.

I. Motor Vehicle Dealer Finance Income

AFSA is concerned about the CFPB's regulatory actions with regard to dealer-originated vehicle financing. These actions are based upon a mere suspicion of "disparate impact" – as opposed to intentional discrimination – based upon an alleged statistical relationship between a vehicle dealer's finance income and the presumed race or ethnicity of a consumer. In fact, the CFPB fails to account for significant market factors impacting the terms of a retail financing contract and the income earned by the dealer when assigning that contract to a finance source. Moreover, the CFPB has resisted transparency at every turn. Left unchecked, this effort could harm motor vehicle sales, stifle competition, reduce consumer choice and increase the cost of credit.

Since the CFPB issued Bulletin 2013-02, "Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act" on March 21, 2013, AFSA has warned of the potential adverse consequences of the CFPB's push for an industry-wide move to a flat compensation scheme for auto dealers. Such a model would rob consumers of their ability to negotiate the financing terms for a new or used vehicle purchase. It could stifle competition among creditors and introduce unforeseen risks to consumers.

The CFPB's fair lending analysis of the portfolios of banks and vehicle finance companies has proven to be rudimentary, and the Bureau seems to fundamentally misunderstand the transaction that occurs between the dealer and a consumer.

In particular, the CFPB:

- Assumes, incorrectly, that the wholesale discount rates at which finance sources buy retail installment sale contracts from dealers would otherwise be available directly to consumers;
- Links differences in dealer finance income to differences in the retail rates that consumers actually pay, without credible evidence to support this relationship;
- Analyzes transactions at assignees' portfolio levels, which can create artificial disparities where none exist at individual dealerships;
- Leaves dealers no choice but to refuse to negotiate lower rates that would benefit consumers; and
- Fails to recognize that neither the dealer nor the eventual assignee collects or maintains information about the applicant's race or ethnicity.

An entire industry should not be radically transformed based on theoretical assignments of race and ethnicity. However, the Bureau has refused calls to provide clarity about its expectations and transparency in its methodology so that the vehicle finance industry may work to eliminate any disparities that do exist – if they exist. Furthermore, the Bureau has chosen to pursue an enforcement-first approach, rather than following the traditional regulatory process of soliciting the views of stakeholders and then publishing a rule that would apply across the industry in a comprehensive manner.

In the meantime, AFSA has commissioned an independent review to assess the current business model of dealership financing and evaluate the costs and benefits of alternative approaches to dealer compensation. It is noteworthy that CFPB Director Cordray's Nov. 4, 2013, response to a bipartisan Senate inquiry revealed that the Bureau undertook no such assessment itself before setting out to upend a business model that has provided affordable credit to automobile purchasers for decades. Nonetheless, AFSA takes the CFPB's concerns seriously and plans to share the results of its study with policymakers. AFSA expects to complete the study in late spring 2014.

II. Creditors and Third-Party Debt Collectors

In the CFPB's recent Advance Notice of Proposed Rulemaking (ANPR) on debt collection, the CFPB's proposed survey on debt collection, and even the CFPB's larger participant rule for debt collectors, the Bureau does not clearly distinguish creditors from debt collectors or debt buyers. The Fair Debt Collection Practices Act (FDCPA) provides clear definitions for both "creditor" and "debt collector." It is unclear why the CFPB – which is charged with implementing the FDCPA – refuses to accept and use these long-established definitions.

The lack of clear, definitive terminology creates a confusing landscape for consumers, and it will impede their ability to properly assess and address any issues that may arise with their financial transactions. It is important to recognize and keep distinct the differences between a creditor and a debt collector, as Congress intended when it passed the FDCPA. The Bureau should not paint all entities that collect amounts due with a broad brush under a premise that all of these entities should have to adhere to the same practices when attempting to collect debts. Imposing burdensome and unnecessary regulatory requirements on creditors that were designed to address the well-documented issues with debt collectors will lead to higher business costs – which will inevitably be passed on to consumers, increasing the cost of borrowing and reducing access to credit. The amorphous use of the terms "debt collector" and "debt collection" without regard to the participant would make it appear that creditors stand in the same shoes as debt collectors, which is simply not the case in practice or under federal law and many state laws.

As Congress understood when it enacted the FDCPA in 1977, creditors have different incentives and therefore do not operate like debt collectors. While much has changed in the consumer credit industry since 1977, today's creditors remain restrained by their inherent motivation to protect their goodwill when collecting past due accounts. While consumers do not choose their debt collector, consumers do make a conscious decision of which creditor to borrow from. Nothing has changed that would merit a different conclusion today or warrant unnecessary regulation.

Most AFSA members originate their own accounts or acquire accounts shortly after origination, and usually well before default. They service these accounts, accept agreed upon payments, and provide assistance throughout the life of the obligation. Delinquent accounts adversely impact a creditor's costs and exposure to risk. There is an incentive to maintain a customer in a paying relationship, as the creditor assumes the risk of extending credit in the first place. As a report from the Tower Group states, "The cost to replace one bank card customer ranges from $160 to over $200, and issuers that work with their customers through this difficult period will retain those customers for life."[1] In other words, creditors use debt collection as a customer retention strategy and are incentivized by avoiding costs to acquire new customers.

In contrast to debt collectors that usually collect only mature, static balances from consumers with whom they have no prior or ongoing relationship, creditors collect delinquent installments from their customers with whom they have a long-term and continuous relationship and who may carry other balances with the creditor that are not delinquent. Unlike debt collectors, attempting to collect on defaulted loans or accounts is not the primary business of a creditor.

Debt collectors do not have substantial "skin in the game" – they typically have little to lose when collecting a delinquent account, which may explain some of the practices the FDCPA was designed to guard against. Creditors, however, have both their capital and the relationship with a valuable customer at stake. Congress recognized that creditors have "skin in the game," which is why creditors are not subject to the same debt collection restrictions as debt collectors.

III. Furnisher Obligations

In September 2013, the CFPB issued a bulletin[2] highlighting furnishers' obligations under the Fair Credit Reporting Act. The CFPB announced in the bulletin that the electronic system e-OSCAR (used by the three largest consumer reporting companies, or CRAs, to forward a consumer dispute to the furnisher) was enhanced to allow CRAs to forward to furnishers not only the consumer dispute, but also supporting documentation provided by the consumer.

The enhancement to e-OSCAR has negatively affected the overall consumer dispute and resolution process. Furnishers now have to spend an exorbitant amount of time sifting through the new documentation sent to them by the CRAs. For AFSA members, this information is often unhelpful and/or irrelevant to the investigation of the consumer dispute. Additionally, it contains sensitive information about the consumer (oftentimes with no nexus to the consumer's relationship with the furnisher). Examples of the information being forwarded by the CRAs include: (1) copies of the consumer's driver's license and social security card; (2) information that is already on file; (3) letters with no reference to a particular dispute; and (4) blank pages and envelopes.

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[1] Moroney, Dennis, "*Revitalize the Credit Card Pre-Charge-off Collection Process and Improve the Bottom Line*." TowerGroup. April 2009. Quoted in "*Leveraging Collections as a Customer Retention Tool,*" by Julie Austin and Vytas Kisielius of Collections & Recovery, TSYS, Jan. 2010. Available at: http://www.ftc.gov/sites/default/files/documents/public_comments/ftc-workshop-debt-collection-2.0-protecting-consumers-technology-changes-project-no.p114802-00007%C2%A0/00007-58348.pdf

[2] CFPB Bulletin 2013-09, "The FCRA's requirement to investigate disputes and review "all relevant" information provided by consumer reporting agencies (CRAs) about the dispute." September 2013.

Although the CFPB consulted with various stakeholders before pushing the CRAs to make the changes to e-OSCAR, it is our understanding that they did not reach out to lenders to assess how the changes would affect their investigation of consumer disputes.

IV. Arbitration

Section 1028(a) of the Dodd-Frank Act requires the CFPB to conduct a study of, and provide a report to Congress concerning, the use of pre-dispute agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services. The Dodd-Frank Act does not specify how the CFPB should conduct such a study. The CFPB proposed, as part of the study, to conduct a national telephone survey of 1,000 credit card holders exploring consumer awareness of and perceptions regarding dispute resolution provisions in credit card agreements.

It appears that, rather than using the survey as a learning tool, the CFPB is using it as a way to attempt to rationalize restricting or banning pre-dispute arbitration agreements. The proposed survey is unnecessary for the completion of the study. The results the CFPB will gather from the survey are obvious from the outset – consumers are not generally aware of the dispute resolution provisions in their credit card agreements. Conducting a survey with an obvious result is not a good use of the CFPB's limited resources, nor a statistically valid, empirically derived method of obtaining relevant data.

There are so many problems with the proposed survey that it will not yield information of sufficient quality for whatever the intended purpose of the survey is. To begin with, the survey is too long, particularly for a telephone survey. The survey lacks detailed statistical measurements. The current survey design will generate very few respondents who are in a position to answer specific questions. The hypothetical questions in the survey should be removed. Hypothetical questions do not necessarily generate responses that predict what a consumer would do in a real-world situation. We understand that the CFPB is revising the survey design that was proposed last year, but to our understanding, these concerns have not been addressed.

The Bureau convened a field hearing as part of its study of arbitration. The problems with this field hearing exemplified the problems with many of the CFPB's public events. The announcement for the field hearing came only ten days in advance. The agenda and panelists were not officially announced before the event. Furthermore, the purpose of the hearing was the CFPB's release of part of its arbitration study. Panelists at the hearing, though, were not given copies of the 168-page study until late in the afternoon the day before the hearing at which they were invited to offer their perspectives. This approach to gathering public input demonstrates an indifference to the views of stakeholders that has become too common in the Bureau's policymaking process.

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AFSA thanks the Financial Services Committee for the opportunity to provide testimony on our industry's experience with the CFPB. If you have any questions, please contact AFSA's Executive Vice President, Bill Himpler, at 202-466-8616 or bhimpler@afsamail.org.

AMERICAN
LAND TITLE
ASSOCIATION

April 8, 2014

The Honorable Shelley Moore Capito
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
U.S. House of Representatives
Washington, DC 20515

The Honorable Gregory W. Meeks
Ranking Member
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
U.S. House of Representatives
Washington, DC 20515

RE: Statement for the Record

Dear Chairman Capito and Ranking Member Meeks:

The American Land Title Association[1] appreciates the opportunity to submit this statement for the record for this hearing entitled "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

ALTA members provide two primary services to consumers and financial institutions. First, the industry prepares and writes title insurance policies protecting both purchasers and mortgagees of real property. This service falls outside the Bureau's regulatory and supervisory authority as part of the business of insurance. Second, title professionals act as third-party settlement agents in real estate and mortgage transactions. This service is within the Bureau's authority pursuant to the Real Estate Settlement Procedures Act.

We have been grateful to have a good working relationship with the Bureau since work began on the recently finalized integrated mortgage disclosures required under Section 1032 of Dodd-Frank, which started before the Bureau opened in July 2011. While we have not agreed on every decision made by the Bureau, they have always been open and willing to listen to the concerns of our industry as they finalized these new rules.

[1] The American Land Title Association, founded in 1907, is a national trade association and voice of the real estate settlement services, abstract and title insurance industry. ALTA represents more than 4,500 member companies. ALTA members operate in every county in the United States to search, review and insure land titles to protect home buyers and mortgage lenders who invest in real estate. ALTA members include title insurance companies, title agents, independent abstracters, title searchers and attorneys, ranging from small, one-county operations to large national title insurers.

1828 L Street, N.W. ■ Suite 705 ■ Washington, DC 20036 ■ (202)296-3671 ■ 202-296-3671 ■ 800-787-ALTA
E-mail: service@alta.org ■ Web: www.alta.org ■ Fax: 888-FAX-ALTA ■ Local Fax: (202)223-5843

The importance of the Bureau working with us increases as the industry begins implementation of these rules and ALTA is actively educating the industry on changes to their business practices and compliance requirements. It is important for Bureau staff and leadership to attend conferences, roundtables and other industry forums. When Bureau staff attends industry meetings and our biweekly information exchange on industry compliance with the mortgage disclosures rule it provides a valuable forum for Bureau staff to hear directly from the people they regulate. This allows staff to get important information about how their rules are working in real life and what issues need clarification.

While ALTA members are not directly supervised by the Bureau, we are indirectly regulated through the Bureau's oversight of both depository and non bank mortgage lenders. As ALTA and its members have sought to gain a better understanding of the Bureau's expectations for lender oversight of third party service providers under its CFPB Bulletin 2012-03, we have not seen the same level of openness from the Bureau as we have experienced from its regulatory function. The result is that businesses are shooting in the dark as they are attempting to invest in systems and processes to protect consumers.

To provide feedback to the business that are struggling to comply, a formal mechanism for more robust communication and outreach between the Bureau and businesses it oversees directly and indirectly about compliance expectations should be established. This could help align business practices to key consumer protection goals and provide regulators with a tool to encourage and incentivize good actors and industry best practices.

Regulatory uncertainty hinders businesses from effectively and efficiently growing and complying with new consumer protection rules. The cost of regulatory uncertainty is most acutely felt by the small businesses that make up the majority of the title and settlement industry. While the Bureau did an admirable job providing industry with clear guidance in its integrated mortgage disclosures rule, despite being almost 1900 pages, there are still areas of uncertainty that make this rule more difficult for the industry to implement this rule.

While the Dodd-Frank Act mandated that the Bureau integrated the disclosures required under RESPA and TILA, it did nothing to integrate the differing underlying substantive requirements of those two statutes. To address this, the Bureau attempted to reconcile those differences where it felt it had authority, but for some areas it left both regimes in place leading to uncertainty about which statute governed. The best example of this problem is the issue of liability.

Both RESPA and TILA have different penalties for violations and mistakes related to their disclosure requirements. In short, TILA includes a private right of action and statutory penalties while RESPA does not. Since the new integrated mortgage disclosures include items that are required under both statutes, the issue of which statutes liability provisions govern each provision in the rule is important. However, despite ALTA requesting such a breakdown in its

comment letter to the Bureau, the Bureau chose not to provide a breakdown and instead require the industry to guess which liability rules govern each provision of the integrated mortgage disclosures rule.

ALTA strongly supports the small business provisions in the Dodd-Frank Act, including the requirement that the Bureau conduct a Small Business Advocacy Review Panel (SBAR) pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) when a rule is expected to have a significant impact on a substantial number of small entities. This process is vital to ensuring that the Bureau's regulatory goals are met in a way that is not overly burdensome on small business. However, ALTA believes that the SBREFA process is ineffective in helping the Bureau understand the impact a rule will have on small business and discovering potentially less impactful alternatives.

A number of process-oriented changes to the panel procedures are necessary to make the SBARs more effective. First, the Bureau should give small entity representatives participating in the SBAR ample notice of the meeting so that they can make appropriate and cost effective travel arrangements. On February 21, 2012, the Bureau sent official invitations to small entity representatives for its March 6, 2012 SBAR panel on this rule. By providing only two weeks' notice, the Bureau made it unnecessarily costly for small entity representatives that do not live in the Washington, D.C., area to attend the panel meeting in person. For example, one ALTA member who attended the panel spent over $1,400 to attend the meeting. This is a substantial sum for a small business owner. The Bureau should aim to give participants at least one months' notice so they can make the appropriate travel arrangements.

Second, the Bureau should work with industry trade associations to better prepare the small entity representatives for the SBAR meeting. One of the main goals of the SBAR panel is to uncover how costly a regulation will be to implement for small business and to identify less-costly alternatives. There are many factors that go into an effective cost estimate (including differences in regional practice and vendor practices) or information about alternatives that can reduce costs for small businesses that are not known to a small business owner unless they have the assistance from their trade association or their vendors. Conducting outreach to trade associations before holding the panel (including inviting trade associations to observe the panel meeting in person) ensures that the SBAR gets the most accurate cost data available.

Third, the Bureau should make the SBAR panel report public once it is complete. By publicizing the report earlier in the regulatory process, the Bureau can provide crucial information to industry stakeholders. This will allow industry to develop more useful data for the Bureau to consider about the impact of their proposals on small business.

Fourth, in addition to the above process-oriented changes, the Bureau also should consider broadening the way it looks at the impact of a regulation on small business. The SBAR

panel focused heavily on the direct costs of this rule on small business, such as software costs, productivity and training but glanced over the parts of this rule that could have indirect but very serious costs on small business. These indirect costs can be extraordinary, including potentially preventing small business from being able to compete in the future marketplace.

An example is the panel's review of the proposals related to who completes the Closing Disclosure. Under the rule, the Bureau makes the lender ultimately liable for the accuracy of the Closing Disclosure even if they partner with a settlement agent to complete the form. While the panel focused on the direct costs of their new form, the indirect costs (namely that lenders would be incentivized to limit the number of small entities with whom they work) will be much more devastating to small business. The Bureau should take greater care to determine whether a proposal will cause business-model shifts that could be harmful to small-business competitiveness.

Lastly, the SBAR is a one shot event that comes late in the regulatory process. The SBAR occurs after the Bureau has decided on the need for a regulation, conducted research to support the regulation, and developed the substantive pieces of the regulation and just prior to a regulation being formally proposed in the Federal Register. This is fairly late in the game and precludes the Bureau from considering, researching and testing alternatives that will be less costly to small business before publishing their proposal. A more effective process would be to have the Bureau consult with small businesses throughout the entire regulatory process.

That is why we support the establishment of an advisory board for small businesses that are non-depository institutions similar to those established for outreach to community banks and credit unions. Advisory boards provide clear, formal and open channels of communication between Bureau staff and industry. Additionally, policymakers should consider creating formal advisory opinion process at the Bureau. This will allow businesses to obtain feedback from the Bureau about new products and processes. This will allow businesses to address consumer protection issues before they invest in a new product.

ALTA appreciates the opportunity to provide this statement for the record. Should you have any questions about this statement, please do not hesitate to contact Justin Ailes, Vice President of Government Affairs at 202.261.2937.

Sincerely,

Michelle L. Korsmo
Chief Executive Officer

The Clearing House
At the Center of Banking Since 1853

Statement for the Record
House Financial Services Committee
"Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"
April 8, 2014

Formed in 1853, The Clearing House Association L.L.C. ("The Clearing House") is the nation's oldest banking association. Today, The Clearing House advocates on regulatory, legislative, and legal public policy issues on behalf of the largest U.S. commercial banks before policy makers, courts of law, and standard setters in the United States and abroad. We welcome the opportunity to present our views on the current state of banking regulation and appreciate the Committee's attention to these issues.

As a result of recent regulatory reform and significantly improved bank capital, liquidity, and risk management practices, the banking system is stronger and safer than it was before the financial crisis. The Clearing House supports these reforms and improvements, including robust capital requirements focused on requiring banks to maintain higher quality capital, new liquidity standards, corporate governance reforms, an improved resolution framework, and recovery and resolution planning. We believe that as a result of these developments collectively, the banking system is more resilient than ever to withstand financial and economic shocks.

As many policymakers and others have observed, just as important as the shape of these regulatory reforms are the process and manner by which they are implemented into regulation. This is especially true of key components of Basel III and the Dodd-Frank Act—like heightened capital and liquidity standards—that touch fundamental aspects of banks' critical credit intermediation function, and as a result may have unintended and potentially negative consequences on the cost and availability of credit or other financial services to consumers and end users if not implemented appropriately. Accordingly, a key challenge in crafting and implementing new rules is to not only identify the prudential benefits of these rules, but also to identify and anticipate such negative consequences and to consider carefully the broader interaction among and between regulatory reforms in the aggregate. The Clearing House continues to urge policymakers to consider the cumulative impact of new regulations, rather than evaluating any one particular regulation in isolation, to ensure that the broader effect of proposed rulemaking on financial markets and the U.S. economy is identified and well-understood *before* these rules are finalized.

An illustrative and pertinent example of this concern is the U.S. banking agencies' recent notice of proposed rulemaking on the liquidity coverage ratio ("LCR"). The Clearing House has filed a comprehensive comment letter with those agencies describing our concerns about the potential

unintended consequences that parts of that proposal could have on consumers, municipalities, and other bank customers, which we summarize below.

U.S. Liquidity Coverage Ratio

In October 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively the "Agencies") issued a notice of proposed rulemaking entitled *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (the "U.S. LCR Proposal").[1] That proposal would implement in the United States a portion of the international liquidity standards agreed to by the Basel Committee on Banking Supervision ("Basel LCR") by establishing an LCR for banking organizations that are mandatorily subject to the "advanced approaches" risk-based capital rules, their respective consolidated subsidiary depository institutions with total consolidated assets greater than $10 billion, and systemically-important nonbank financial companies designated by the Financial Stability Oversight Council that do not have substantial insurance activities.

The Clearing House believes that the final Basel LCR generally strikes an appropriate balance between accurately capturing liquidity risk and the concerns raised by banks during the public comment period with respect to, among others, the measurement of that risk and the scope of oversight and related compliance requirements. However, we are concerned that the U.S. LCR Proposal deviates significantly from the Basel LCR. These deviations detract from the goals of clarity and transparency across markets, competitive equality, and minimizing opportunities for regulatory arbitrage and the potential balkanization of national markets. We strongly believe that the LCR as implemented in the United States should deviate from the Basel LCR in significant ways when, and only when, unique circumstances impacting the liquidity risk of U.S. banks warrants such deviation. The effects of U.S. divergence from the Basel LCR may be exacerbated because of the interplay among the host of new regulations relating to capital, leverage, and other prudential standards.

In particular, two specific provisions of the U.S. LCR Proposal — the treatment of the secured deposits of U.S. municipalities and other public sectors entities ("PSEs") and the treatment of U.S. municipal securities — could have negative unintended consequences for U.S. municipalities and PSEs and their constituents.

1. <u>The treatment of secured deposits of U.S. municipalities and PSEs as secured funding transactions may impair the ability of banks to provide this critical service.</u>

Under the U.S. LCR Proposal, the required amount of high-quality liquid assets ("HQLA") is based on the assumed unwind of "any secured funding transaction, secured lending transaction, asset exchange, or collateralized derivative transaction that matures within 30-calendar days of the calculation date and where the [BANK] and the counterparty exchange HQLA."[2] The stated purpose of this mechanism is generally "to prevent a covered company from having a substantial amount of

[1] 78 Fed. Reg. 71,818 (Nov. 29, 2013).
[2] Proposed Rules, §§21(f)(1), (2) and (3).

transactions that would create the appearance of a significant Level 1 liquid asset amount at the beginning of the 30-day stress period, but would unwind by the end of the 30-day stress period."[3] The core focus of this issue as set forth in the U.S. LCR Proposal appears to be "certain repurchase and reverse repurchase transactions"[4] — presumably due to the fairly ready ability to finance higher quality HQLA on the balance sheet through posting lower quality HQLA to a counterparty given the depth and scope of the U.S. repurchase/reverse repurchase market. While we acknowledge that there may be transactions and arrangements which could give rise to this issue, certain other arrangements which would seemingly be covered by a literal reading of the U.S. LCR Proposal do not in fact pose any material risk of a bank "manipulat[ing] its HQLA portfolio."[5]

In particular, we do not believe that deposits of U.S. municipalities — that under applicable state law[6] must be collateralized with liquid assets by the relevant depository institution — should be covered by the unwind mechanism because these deposits are fundamentally different in nature than typical secured funding transactions normally entered into by banks and pose very little risk of manipulation for purposes of the LCR and the pool of HQLA. As recognized in the Federal Deposit Insurance Act,[7] the laws of various states require that the deposits of certain municipalities and other PSEs must be "secured or collateralized" by the insured depository institution that holds such deposits. The amount of such deposits in the U.S. is significant, totaling approximately $443.6 billion as of September 2013.[8] These types of secured deposit arrangements are a critically important component of the suite of banking products provided by the banking industry to PSEs.

Secured municipal deposits are significantly different in nature than other types of secured funding transactions where banks, at their discretion, seek funding to finance their trading securities inventory from money market funds and other broker-dealers in the wholesale funding markets. From the perspective of a depository institution, secured municipal deposits are fundamentally first and foremost deposits where the customers, in this case various municipalities, seek to place their funds on deposit at the bank.

Moreover, these deposits tend to be stable, exhibiting relatively low volatility, and institutions use more stable portfolio collateral (as opposed to trading assets) to secure these types of balances. While literally "secured funding" for purposes of the U.S. LCR Proposal, municipal deposits are simply not the type of transactions susceptible to the risk of manipulation that the U.S. LCR Proposal and the Basel LCR apparently were focused on in this context as discussed above. In addition, empirical evidence indicates that, even during times of macroeconomic stress affecting the banking industry such as the 2008 financial crisis, secured deposits of PSEs generally experience only low withdrawal rates.

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[3] Preamble to the Proposed Rules at 71,832.
[4] *Id.* at 71,831.
[5] Preamble at 71,831.
[6] *See e.g.*, Ohio R.C. §§ 135.18, 135.181 and 135.37; 72 P.S. §§ 505 and 3836-1 *et seq.*
[7] *See* 18 U.S.C. 1831(m)(4).
[8] Based on data available from SNL Financial LC.

In addition, discouraging banks from providing secured deposit services to U.S. municipalities and other PSEs appears contrary to public policy goals. If secured deposits are indeed required to be unwound for purposes of the HQLA calculation, institutions subject to the U.S. LCR Proposal may have a strong incentive to stop offering these products to PSEs altogether because of the highly negative impact on their LCR calculations. Without ready and cost-effective access to banking services to manage their funds and operational deposits, many U.S. municipalities could have substantial practical difficulties in continuing to provide critical public services to their citizens, meeting their payroll for public servants, and more generally paying their day-to-day bills. We firmly believe this was not an intended consequence of the U.S. LCR Proposal.

If the Agencies nevertheless determine to subject secured municipal deposits to some form of unwind mechanism for purposes of the HQLA calculation under Section 21 of the U.S. LCR Proposal, we urge that the final U.S. LCR permit the use of the applicable LCR outflow assumption under Section 32 of the Proposal, subject to the proposed maximum of 15% and irrespective of the type of collateral being utilized, when performing the unwind calculation. We believe this treatment would be justified as a Country-Specific Circumstance because secured municipal deposits in the U.S. context are a fundamentally different type of secured funding due to the particular requirements of U.S. state law and an unwind of such deposits for purposes of the HQLA calculation would presumably only occur if and to the extent the deposit is withdrawn and a resulting outflow of cash and increase in HQLA, if any, occur. Additionally, bank call report data suggests that, even during the financial crisis for the quarters ending December 31, 2007 through September 30, 2009, peak secured municipal deposit run-off rates generally did not exceed approximately 15%.

2. The deep, liquid markets for obligations of U.S. municipalities strongly support their inclusion as HQLA.

Under the U.S. LCR Proposal, municipal securities, including debt securities issued by state or local governments, agencies, and authorities, do not qualify as HQLA as "the agencies believe, at this time, these assets are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule."[9] With nearly $3.7 trillion of securities and loans outstanding,[10] municipal securities play a critical role in the financing of our capital investment in public services and infrastructure and are an important part of the U.S.'s capital markets. We believe that municipal securities should be treated as Level 2A liquid assets. Municipal securities meet the requirements for HQLA outlined in the U.S. LCR Proposal and in some respects are safer and more liquid than assets recognized as HQLA.

The Preamble to the U.S. LCR Proposal describes the characteristics of assets that qualify for inclusion as HQLA, such as assets that are "easily and readily valued" and "lower risk", "do not incur sharp price declines", benefit from "active outright and repurchase markets at all times with significant diversity in market participants as well as high volume", and may be "pledge[d] at a central bank as

[9] Preamble at 71,827.
[10] Board of Governors of the Federal Reserve System, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2013, Table L.211, page 98.

collateral for intraday liquidity needs and overnight liquidity facilities."[11] Municipal securities exhibit all of these qualities. The municipal market is liquid with a diverse mix of participants, including retail and institutional investors as well as over 1,650 registered dealers,[12] and price quotes are readily available from dealers on almost any transaction. The municipal trading market is also robust, with a higher daily turnover rate in 2012 than the turnover rate for corporate bonds.[13] Furthermore, based on historical performance, municipal securities are arguably more price-stable and do not experience any greater loss of liquidity during periods of stress than other securities which are considered HQLA under the U.S. LCR Proposal. For example, the cumulative ten-year default rate for BBB-rated municipal securities is 0.3% while BBB-rate corporate bonds exhibit a 4.74% cumulative ten-year default rate.[14] Finally, banks subject to the proposal may use municipal bonds as collateral for discount window advances as well as to offset risks associated with extensions of daylight credit of master account activity.[15]

In addition, the U.S. LCR Proposal's treatment of municipal securities is inconsistent with the treatment recommended by the Basel Committee. Under the Basel LCR, "marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks" are treated as Level 2A liquid assets where PSEs include governmental entities other than a central government including U.S. state and local governments.[16] U.S. municipal securities meet the criteria outlined in the Basel LCR and any departure from the Basel LCR is not warranted by Country-Specific Circumstances. Therefore, the Agencies should align their treatment of municipal securities with the Basel LCR and assign municipal securities to Level 2A.

Interaction between the U.S. LCR Proposal and Other Rulemakings

A key challenge for the Agencies and other regulators, including securities and commodities regulators in the United States as well as banking and other functional regulators in other countries, has been to anticipate and accommodate the interaction among and between macroprudential initiatives. In this respect, it is important to fully evaluate the extent to which the U.S. LCR Proposal could interact with various other rules in ways that are unproductive and likely unintended. For example, while the U.S. LCR Proposal would require covered banks to hold large amounts of HQLA in specified types, a pending U.S. leverage ratio proposal would effectively penalize such holdings by requiring capital for such holdings well in excess of their actual risk.[17] This dynamic would both (i) cut directly against the

[11] Preamble at 71,827.
[12] Municipal Securities Rulemaking Board, "MSRB Registrants," www.msrb.org/msrb1/pqweb/registrants.asp.
[13] Based on the average daily trading volume in relation to total volume outstanding, in 2012 0.35% of total outstanding municipal securities traded each day versus 0.24% of outstanding corporate bonds. *See* Board of Governors of the Federal Reserve System, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2013 Table L.212, page 99 (based on $11.1 trillion of corporate bonds outstanding on December 31, 2012 from data on "Nonfinancial corporate business" and "Financial sectors" including sub-investment grade).
[14] BNY Mellon Wealth Management, "Muni Bond Defaults, Bankruptcies and Bondholder Protections," August 2013, page 1.
[15] Federal Reserve System, "Federal Reserve Collateral Guidelines," January 2, 2013, page 3.
[16] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, ¶ 52 (January 2013).
[17] Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101 (Aug. 20, 2013).

global policy consensus around limiting liquidity risk as a threat to banks and markets, which is at least as important as addressing the risk of insufficient leverage capital and (ii) inevitably increase risks for banks and the financial system in times of stress by incentivizing banks to respond to that penalty by holding a lesser amount of HQLA than they otherwise would.

Similarly, the U.S. LCR Proposal interacts with recently-issued final rules by the Commodity Futures Trading Commission ("CFTC") relating to liquidity requirements for derivatives clearing organizations ("DCOs"). The CFTC rules require systemically-important DCOs, which are central counterparties ("CCPs") that have registered with the CFTC, to establish and maintain specified liquidity resources. The CFTC rulemaking, while only applicable to a subset of DCOs, is intended to implement the international Principles for Financial Market Infrastructures ("PFMIs") and is illustrative of the PFMI requirements that will be applicable to CCPs more broadly. We believe that the U.S. LCR Proposal does not anticipate CCP liquidity arrangements, which are generally designed as "back-up" liquidity resources to be used only when CCPs' balance sheet cash, initial margin and default fund cash resources are insufficient to meet CCPs' short-term liquidity requirements. As a result, we are concerned that a "100% outflow" treatment might apply to these arrangements, which is far in excess of historical drawdown rates. Such high drawdown rates, if applied, may materially increase the costs of clearing, impeding efforts to move more uncleared transactions to CCPs.

In addition, the U.S. LCR Proposal also interacts with proposed rules issued by the Securities and Exchange Commission ("SEC") in 2012 to establish regulatory liquidity standards for alternative net capital broker-dealers ("ANC B-Ds") and security-based swap dealers ("SBSDs").[18] Although all ANC B-Ds are controlled by banks subject to the U.S. LCR Proposal,[19] neither the SEC proposal nor the U.S. LCR Proposal addresses the interaction of these two proposed liquidity regimes. If the U.S. LCR Proposal and the SEC Liquidity Proposal are each finalized as proposed, banks controlling ANC B-Ds or SBSDs will be subject to uncoordinated, inconsistent requirements that could weaken centralized liquidity management. We recommend that the Agencies and the SEC should coordinate their rulemakings to establish a workable regime that promotes centralized liquidity management.

Conclusion

Although the U.S. LCR Proposal is only one example, it is apparent that implementation of post-crisis regulatory reform requires careful attention to both (i) the potential unintended consequences of proposed rules for businesses and consumers and (ii) the cumulative interaction and effect of these proposed rules. The Clearing House is committed to continuing to play a constructive role in the financial regulatory reform process by engaging with policymakers on how best to implement important policy measures in a thoughtful, complementary manner.

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[18] 78 Fed. Reg. 71,818, 71,852-54 (Nov. 29, 2013). See 17 C.F.R. §§ 15c3-1(f), 18a-1(f) (proposed).

[19] There are currently six ANC B-Ds, most of which are controlled by U.S. banking organizations. A foreign banking organization that controls an ANC B-D would likely be required to establish an intermediate U.S. holding company to control the ANC B-D under the Board's proposed foreign banking organization rulemaking. See 77 Fed. Reg. 76628 (Dec. 28, 2012).

CBA | CONSUMER BANKERS ASSOCIATION

The Voice of the Retail Banking Industry

April 8, 2014

The Honorable Jeb Hensarling
Chairman
Financial Services Committee
US House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Financial Services Committee
US House of Representatives
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

The Consumer Bankers Association (CBA)[1] commends you for calling today's hearing to examine the current regulatory landscape of our financial services industry and appreciates your continued oversight of the rules and regulations governing financial institutions. Even as the U.S. banking industry faces an unprecedented regulatory environment, CBA member financial institutions work daily to fulfill the needs of their customers and communities – thus not just contributing to but leading the sustainable economic growth and recovery in the U.S. Consumer and small business lending are growing as banks are meeting new regulatory obligations in a timely manner without imposing burdens on their customers.

Following the financial crisis of 2008, Congress responded with a thorough overhaul of the outdated laws governing our nation's financial system and created a new set of policies to protect consumers. While many of those changes were necessary for a complex and rapidly changing system that had outgrown its regulations, much of the interpretation of Congress' intent was left to regulatory agencies to determine how best to apply new laws to the industry. Unfortunately, some steps taken by regulatory agencies in the name of consumer protection and safety and soundness may have run counter to Congress' intent by limiting consumer choice, transparency, and market competition, while pushing vulnerable consumers to more expensive and often less regulated financial services providers.

One year ago, the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) issued nearly identical proposed supervisory guidance to clarify the agencies' application of principles of safe and sound banking practices and consumer protection in connection with deposit advance products (DAP). DAP, which are now no longer being offered to consumers by CBA member institutions, were created to serve consumers in critical need of short-term, small-dollar credit who did not qualify for other traditional credit products. These were not closed-end loans; they were lines of credit that were repaid automatically from a verified recurring direct deposit. The maximum amount advanced was

[1] The Consumer Bankers Association (CBA) is the trade association for today's leaders in retail banking - banking services geared toward consumers and small businesses. The nation's largest financial institutions, as well as many regional banks, are CBA corporate members, collectively holding two-thirds of the industry's total assets. CBA's mission is to preserve and promote the retail banking industry as it strives to fulfill the financial needs of the American consumer and small business.

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limited to the lesser of a cap (typically $500) or a percentage of the average recurring payment (e.g. 50%). The terms of the DAP were clear and easy to understand.

Consumer satisfaction with DAP was extremely high. For several reasons, DAP offered consumers a vastly superior option to other low-dollar short-term financing such as non-depository payday loans, pawn brokers, and title loans. DAP were only available to bank customers with established checking account relationships in good standing and included features such as maximum loan size and cooling off periods to prevent consumers from becoming overly reliant on the product. These products were offered by banks for many years and – appropriately – were highly regulated for consumer protection and safety and soundness concerns.

There has always been, and will always be, a need for small-dollar, short-term credit. Historically, the FDIC and other prudential regulators have encouraged depository institutions to meet this particular consumer credit need. However, after the OCC and FDIC finalized their guidance late last year, banks offering DAP quickly decided to cease offering the product.

The decision was made for several reasons, but primarily because the guidance would have required banks to use more traditional underwriting and in addition, overlay a cash flow analysis that would not have been well suited to deposit advances and would have increased the cost of the product. Regulators assumed consumers were using their checking accounts to build reserves or savings as opposed to using them as transactional accounts, an assumption contrary to the purpose of a traditional checking account. Additionally, even though bank-offered DAP imposed a mandatory cooling off period, the FDIC and OCC guidelines would have required each deposit advance to be repaid in full before the bank could extend another deposit advance, and banks were discouraged from offering more than one advance per monthly statement cycle. These guidelines were inconsistent with the structure of DAP which provided immediate access to the exact amount of money needed. By limiting a customer to one deposit advance per month, banks were concerned customers would have been encouraged to take a larger amount than was needed "just in case," which would have resulted in higher overall costs.

For these reasons, the CBA strongly encouraged the FDIC and OCC to withdraw its guidance and to work with the industry on a practical solution – to build a foundation to fully support short-term lending needs. Though there are some positive signs of economic recovery in the U.S., unfortunately a large number of Americans have yet to feel the positive impact. According to the American Payroll Association, in data released on March 26, 2014, more than two-thirds of Americans stated they live paycheck to paycheck. Sixty-eight percent of survey respondents said it would be "somewhat difficult" or "very difficult" if their paychecks were delayed just one week. Limiting banks' ability to serve the small dollar loan market leaves consumers with more costly alternatives and will drive them out of the regulated financial services industry. Because

of this, they will ultimately face the prospect of further late payments, nonsufficient funds and returned check fees ultimately driving up the costs.

CBA members also have seen regulations limiting consumer choice in the area of providing student loans. Congress decreed in 2010 that, despite the fact that most colleges preferred the bank-based guaranteed loan program, it would replace that program with a direct government loan system. Today, the federal government's Direct Loan Program makes up about 93 percent of all loans to college students and their parents. The remaining, relatively tiny, private student loan business, despite being small, is highly regulated in ways that are often excessive and costly.

Banks must make 16 distinct disclosures to borrowers three separate times before originating a private student loan. Bank lenders also are subject to scrutiny by both their prudential regulators, such as the OCC or FDIC, and the CFPB, which has special authority to supervise all student loan programs no matter how small on behalf of consumers. This is a major administrative burden for banks.

Private student loans are borrowed for various reasons, usually to supplement federal student aid, but sometimes because borrowers simply would prefer not to be in debt to the government. These loans make higher education possible for thousands of students every year. Despite the fact that only a few banks participate in student lending in a major way, and the volume of private student loans is tiny compared to federal student loans, private lenders are often incorrectly perceived as the cause of the student loan debt problem. It is an absurd position, given that the government has 93 percent of the student loan market.

Banks answer with facts: the performance of private student loans is exemplary, with delinquency rates by the major lenders hovering in the three percent range. But the potential for negative publicity is such that despite the performance of private loan portfolios, the small size of the remaining private loan marketplace, and the duplicative regulation of the business leaves banks wondering if it is worthwhile to continue.

Bank behavior and impact on consumer options going forward on a number of issues is still yet to be determined based on either recent regulatory guidance or by rules yet to be written. Specifically:

- Only time will tell how the QM mortgage rules will impact the non-QM market.
- The CFPB's approach to supervising and enforcing the indirect auto finance industry has raised numerous questions about how to price loans and monitor for fair lending compliance.
- Section 1071 of the Dodd-Frank Act amends the Equal Credit Opportunity Act (ECOA) to create a HMDA-like set of requirements for small business credit applications. While

CBA CONSUMER BANKERS ASSOCIATION
The Voice of the Retail Banking Industry

no rules have been promulgated to date, the statutory provisions as written would have a significantly negative effect on small business lending.

CBA's members stand ready to work with the prudential regulators to find practical solutions to balance consumer protection with responsible access to credit for our customers.

We appreciate the opportunity to comment on today's hearing.

Sincerely,

Richard Hunt
President and CEO
Consumer Bankers Association

Statement for the Record

Of

Consumer Bankers Association

Credit Union National Association

Electronic Funds Transfer Association

The Electronic Transactions Association

Independent Community Bankers of America

National Association of Federal Credit Unions

Third Party Payments Processors Association

United States House of Representatives

Committee on Financial Services

Hearing on:

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

April 8, 2014

Chairman Hensarling, Ranking Member Waters and Members of the Committee, CBA, CUNA, EFTA, ETA, ICBA, NAFCU, and TPPPA appreciates the opportunity to submit this statement for the record for the Committee's hearing, "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

Consumer Bankers Association (CBA)

The Consumer Bankers Association is the only national financial trade group focused exclusively on retail banking and personal financial services — banking services geared toward consumers and small businesses. As the recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation for its members. CBA members include the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the total assets of depository institutions.

Credit Union national Association (CUNA)

The Credit Union National Association (CUNA) is the largest national trade association in the United States serving America's credit unions. The not-for-profit trade group is governed by volunteer directors who are elected by their credit union peers from across the nation. With its network of affiliated state credit union associations, CUNA serves America's nearly 7,000 credit unions, which are owned by more than 98 million consumer members.

Electronic Funds Transfer Association (EFTA)

Now in its 4th decade, the Electronic Funds Transfer Association (www.efta.org) is a professional association dedicated to the advancement of electronic payments and commerce. Its

objective is to inform debate over the consumer, business and policy implications of new and existing payments technology. It does this through public outreach to Congress, the administrative agencies, regulators, consumers and the media.

Electronic Transactions Association (ETA)

ETA is an international trade association representing companies that offer electronic transaction processing products and services. The purpose of ETA is to help the businesses acquiring industry by providing leadership through education, advocacy, and the exchange of information. ETA's membership spans the breadth of the payments industry, from financial institutions and transaction processors to independent sales organizations and equipment suppliers to businesses. More than 500 companies worldwide are members of ETA. www.electran.org

Independent Community Bankers of America (ICBA)

The Independent Community Bankers of America® (ICBA), the nation's voice for nearly 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.

ICBA members operate 24,000 locations nationwide, employ 300,000 Americans and hold $1.3 trillion in assets, $1 trillion in deposits and $800 billion in loans to consumers, small businesses and the agricultural community. For more information, visit www.icba.org.

National Association of Federal Credit Unions (NAFCU)

The National Association of Federal Credit Unions is the only national organization that focuses exclusively on federal issues affecting credit unions, representing its members before the federal government and the public. NAFCU member credit unions collectively account for approximately 69 percent of the assets of all federally chartered credit unions.

The Third Party Payments Processors Association (TPPPA)

The Third Party Payments Processors Association (TPPPA) is a national not-for-profit industry association representing and promoting the interests of the payment processors, their financial institutions and their merchants. TPPPA advocates on behalf of its members to the industry and government, educates its members on the latest rules and regulatory updates, and provides comprehensive tools to support operational excellence and integrity in payments. To learn more about the TPPPA, visit the website ww.tpppa.org.

We write to express our concerns with the Financial Fraud Taskforce's initiative "Operation Choke Point." We fully support the federal government's role in fighting fraud and ensuring the integrity of markets, but we are concerned that Operation Choke Point's broad and overly aggressive enforcement tactics undermine its effectiveness and create serious risks to consumers and the economy. First, Operation Choke Point is imposing ill-considered and costly mandates on payment systems, which will ultimately result in higher prices and reduced services for consumers. Second, Operation Choke Point threatens to close access to the financial system to law-abiding businesses, because the mere prospect of an enforcement action is sufficient to cause financial institutions to restrict access to their payment systems to only established companies that present low risks. While preventing fraud is a top concern, it needs to be balanced with ensuring that businesses and consumers that operate in accordance with applicable laws can still access payment systems. Finally, the disruption of commerce caused by Operation Choke Point could have adverse economic consequences, especially for the growth of e-commerce. Online businesses are more likely to have business models that Operation Choke Point would view as risky (even though they are lawful businesses). As a result, they are more likely to be restricted from accessing payment systems out of an overabundance of caution, even if they have adequate and balanced controls to mitigate this higher risk. Accordingly, Operation Choke Points, if left unchecked, could seriously deter the natural growth and development of e-commerce and stifle future economic growth.

We believe that a better approach is to permit the payments industry to carry-out its ongoing efforts to strengthen practices and technologies aimed at protecting consumers from unscrupulous businesses. We support industry efforts to strengthen internal controls or processes for institutions that provide payment processing services for customers engaged in higher-risk activities. These should include risk assessments, due diligence to determine if customers are operating in accordance with applicable law, and ongoing systems monitoring . Regulators and law enforcement should not prohibit or discourage these institutions, regardless of their size, from serving these customers provided adequate and balanced controls are in place.

* * *

We would like to thank the Committee for this opportunity to present this statement for the record on this important topic. If you have any questions about this statement or the issues discussed, please contact the respective trade associations.

CFSA
COMMUNITY FINANCIAL SERVICES
ASSOCIATION OF AMERICA
A COMMUNITY OF RESPONSIBLE LENDERS

515 KING ST., SUITE 300
ALEXANDRIA, VA 22314-3137
PHONE: 888.572.9329
FAX: 703.684.1219
E-MAIL: INFO@CFSAA.COM
ONLINE: WWW.CFSAA.COM

Community Financial Services Association of America
Statement for the Record
House Financial Services Committee
"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

April 8, 2014

I. Overview

The Community Financial Services Association of America ("CFSA") was formed in 1999 to promote laws and regulations that protect consumers while preserving access to credit options and to support and encourage responsible practices within the payday loan industry. CFSA's member companies represent more than half of all traditional payday loan storefronts across the country, in more than 30 states. Our members provide payday loans to more than 19 million households, as well as a wide range of other financial products and services, including bill payment, check cashing, installment loans, prepaid debit cards, and tax preparation services.

Our members' storefront locations put us in the heart of many financially underserved communities. CFSA members are heavily regulated at the federal level and in the individual states where they operate. Additionally, to serve our customers responsibly, CFSA has developed a set of 13 Best Practices that begin with compliance with all applicable state and federal laws (See Attachment A for a list of these Best Practices). They cover everything from advertising to collection practices. Our members hold themselves to a higher standard, and we believe that these practices differentiate our members from other providers in the short-term credit industry.

CFSA appreciates that the Committee is examining how regulatory red tape impairs economic freedom in the United States. Right now the payday lending industry is an example of how regulatory overreach can harm both businesses and consumers. The Department of Justice ("DOJ"), in concert with the federal banking regulators is carrying out a program called "Operation Choke Point," whose effort, intended or not, cuts off access to basic banking services for payday lenders. Originally this program was described as an attempt to prevent illegal bad actors from accessing the U.S. banking system, an effort CFSA supports. However, Operation Choke Point has gone well beyond attempting to keep fraud and abuse out of the banking system and appears to be an effort to prevent all payday lenders from having banking relationships, even those that are legally state chartered and licensed.

CFSA has very serious concerns about the profound detrimental impact on legitimate, law-abiding payday lenders and their customers caused by Operation Choke Point. Operation Choke Point is a coordinated federal effort to prevent fraudulent actors from accessing the banking and payments system that has caused many payday lenders and other targeted industries that are operating in full compliance with all applicable federal and state laws to lose their banking and automated clearing house ("ACH") business relationships. This federal initiative does not distinguish between financial fraudsters and legitimate businesses, such as payday lenders, that are operating legally, in

compiance with all applicable state and federal laws and regulations. It appears that Operation Choke Point has extended its aim beyond bad actors, and has taken aim at lawful products and services that regulators dislike. The breadth of Operation Choke Point extends throughout the nonbank financial services industry to numerous legitimate businesses that offer alternative consumer credit options, including payday loans, and has even affected totally unrelated industries that regulators similarly dislike. This federal initiative is an inappropriate exercise of regulatory authority.

Of great concern to CFSA, this initiative is expanding aggressively with no apparent regard for the serious negative effects on consumer choices of responsible financial products and consumer access to credit options. For nearly 40 million underbanked consumers, Operation Choke Point is limiting choices among responsible financial products, particularly for short-term, small-dollar credit.

An American Banker article published on March 17, 2014 posed questions about whether these untested regulatory changes, which are being experimented with on an "economy still struggling to return to normality," are affecting consumer's access to credit (See Attachment B).[1] The article asked, "The bank regulatory system has traditionally relied on the professional regulation of financial institutions, operating as much as possible beyond the realm of political allegiance. But will this continue to be the case given the new and broader roles being played by the DOJ, CFPB, Treasury and FSOC?"

A subsequent American Banker article published by William Issac, former chairman of the FDIC, on March 21, 2014, also expressed concerns about Operation Choke Point (See Attachment C).[2] Issac states, "History teaches that when government bureaucracies try to direct economies, stifled creativity, distorted markets and low economic growth are inevitable results. One of the easiest and most insidious ways for bureaucrats to control the U.S. economy is through the banks, directing who gets – and who can't get – loans and other essential banking services. That's happening today, and it ought to alarm and frighten all of us."

Our association has numerous examples of how Operation Choke Point has adversely impacted licensed and legally compliant members. This widespread federal attack on the payday lending industry is hurting CFSA members, countless other businesses and industries, and the customers who rely on these lawful products. If Operation Choke Point is allowed to continue on its current path, the precedent that it will create – that government regulators may secretly work to thwart lawful businesses and the customers they serve, without according them any transparency or other due process rights – is extremely concerning to say the least.

II. Background of Operation Choke Point

The features of Operation Choke Point have unfolded over time through a series of articles about the government's actions, a training presentation and reports from industry. In late summer 2013,

[1] Thomas Vartanian, *How Many Bank Supervisors Do We Need?*, March 17, 2014, available at http://www.americanbanker.com/bankthink/how-many-bank-supervisors-do-we-need-1066286-1.html

[2] William Issac, *DOJ's 'Operation Choke Point': An Attack on Market Economy*, March 21, 2014, available at http://www.americanbanker.com/bankthink/dojs-operation-choke-point-an-attack-on-market-economy-1066421-1.html

the payday lending industry learned that the Financial Fraud Enforcement Task Force (part of DOJ), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of Currency ("OCC"), and potentially other regulators secretly began working together to pressure community banks and third party payment processors to reconsider use of ACH for online payday lenders. This coordinate interagency initiative, labeled Operation Choke Point, is being run for the stated purpose of limiting fraudulent activity in the financial system.

This initiative became widely known about on August 7, 2013, when the Wall Street Journal first reported that the government had issued subpoenas to banks and other companies that handle payments for an array of financial products as part of the ramp-up of investigations (See Attachment D).[3] A subsequent American Banker article reported on March 27, 2014 that under Operation Choke Point, the DOJ had sent subpoenas to more than 50 banks and payment processing firms (See Attachment E).[4]

Although the DOJ alleges that its inquiries are only for the purpose of learning information about bad actors engaged in financial fraud and deception[5], dozens of legally-compliant, licensed businesses, including many payday lenders, have lost ACH access to the payments system, and have had their relationships with banks terminated as a result of this initiative. It is becoming increasingly apparent that the DOJ is sending subpoenas, and that other federal regulators are taking actions, with the intent of pressuring banks to terminate all business relationships with payday lenders.

On September 17, 2013, the lead prosecutor for Operation Choke Point, a trial attorney in the DOJ's Consumer Protection Branch, confirmed many of the concerns of bias against the industry when he briefed a meeting of bank examiners on the program's efforts. He outlined the plan to cut off authorized and unauthorized access to the payment systems before even investigating evidence of consumer fraud during a training presentation sponsored by the Federal Financial Institutions Examination Council (See Attachment F).[6] According to this presentation, Operation Choke Point has had "collateral benefits" regarding Internet payday lending.[7]

CFSA, of course, fully supports efforts to eliminate illegal operators and bad actors from the marketplace. It is, however, extremely problematic that these federal agencies, many of which do not have regulatory authority over payday lending product, are engaged in efforts which are having the effect of chilling access to credit for millions of consumers. It is also problematic that federal agencies are targeting a financial product that has been enacted into law by state governments, at the request of their constituents. This raises serious questions about the overreach of government.

[3] Alan Zibel and Brent Kendall, *Probe Turns Up Heat on Banks*, August 7, 2013, available at http://online.wsj.com/news/articles/SB10001424127887323838204578654411043000772

[4] Kevin Wack, *Fed, OCC Get Flak from Capitol Hill over Targeting of Online Lending*, March 27, 2014, available at http://www.americanbanker.com/issues/179_60/fed-occ-take-flak-from-capitol-hill-over-online-lending-probe-1066547-1.html

[5] Alan Zibel and Brent Kendall, *Probe Turns Up Heat on Banks*, August 7, 2013, available at http://online.wsj.com/news/articles/SB10001424127887323838204578654411043000772

[6] Michael Benardo, Joel Sweet, Jennifer LaRoche, *Third Party Payment Processors: Relationships, Guidance, and Case Examples*, (September 17, 2013) available at http://www.microbilt.com/communications/FDIC-OCC-DOJ-Presentation%2891713%29.pdf

[7] *Id.*

III. Overreach of Federal Regulators into the Payday Lending Industry

Pursuant to Dodd-Frank Wall Street and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Consumer Financial Protection Bureau ("CFPB") has supervisory, regulatory and enforcement authority over the payday lending industry.[8] The Federal Trade Commission ("FTC") also has some enforcement authority over the payday lending industry (See Attachment G for a discussion of federal regulatory authority for payday lending).

The CFPB and the FTC are the only federal regulators that Congress has given direct authority to regulate the payday lending industry. Yet under Operation Choke Point, other federal regulators (including, for example, the OCC, FDIC, and DOJ) are improperly exerting their power to effectively regulate payday lenders by pressuring other financial institutions into undertaking action detrimental to the payday lending industry, and they are doing this with respect to payday lenders who are fully compliant with all applicable law. This regulatory overreach, described in greater detail below, is unwarranted and unjustified.

IV. Operation Choke Point Effects on Consumers and Industry

A. ACH Access

Even before first learning about Operation Choke Point, many different CFSA members had informed the association that they had received notice that their ACH processors were ceasing to do business with them. Additionally, CFSA received numerous reports from members about federal bank examiners, who either directly or by implication, insinuated that conducting business with licensed and regulated payday lenders is a bad business practice.

As an example, in early fall 2013, a CFSA member's ACH processor informed it that the originating depository financial institution ("ODFI") used to process its storefront transactions had decided to cease processing ACH transactions for payday lenders as a result of suggestions made by its federal regulators. The CFSA member company was given only three weeks to replace the ODFI, which it was unable to accomplish in that timeframe. While the company has since established a new relationship, their business was significantly disrupted as a result of the ODFI's decision, which was based on its regulator's suggestion. This is just one of many different examples CFSA has learned of about a state-licensed and legally compliant lenders losing ACH access due to pressure received from banks.

As a result of the reports of a "whisper campaign" targeting the industry, 31 members of Congress sent a letter to FDIC Chairman Martin Gruenberg and DOJ Attorney General Eric Holder (See Attachment H). The letter stated,

> "We are especially troubled by reports that the DOJ and FDIC are intimidating some community banks and third party payment processors with threats of heightened regulatory scrutiny unless they cease doing business with online lenders. As a result, many banks and payment processors are terminating relationships with many of their long-term customers who provide underserved consumers with short-term credit options."

[8] 12 U.S.C. 5514(a)(1)(E).

In part, in response to this questioning from lawmakers, the FDIC issued a letter[9] on Sept. 27, 2013, clarifying its policy and supervisory approach related to payment processing relationships with merchant customers (See Attachment I). In this letter, the FDIC stated that institutions which correctly manage their third-party relationships, "are neither prohibited nor discouraged" from processing payments for legal entities and that, "those that are operating with the appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law." Despite this written assurance from the FDIC, legally compliant businesses have in fact continued to lose ACH access under pressure from regulators.

B. Termination of Banking Relationships

In the wake of Operation Choke Point, CFSA has learned of numerous examples of banking institutions terminating their business relationships with dozens of their payday lending clients, who are operating in full compliance with applicable law. Some of these banks specifically noted their concern that working with payday lenders was receiving heightened scrutiny from prudential regulators. In other instances, the banks specifically cited "reputational risk" and "safety and soundness" as the bases for termination of business relationships with payday lenders. In most cases, however, these banks provided little to no detail or explanation regarding the reasons for the termination. Some banks merely stated that the decision had been made, citing no rationale for the decision or a vague reference to risk.

The prudential regulators have maintained, and continue to maintain, that bank customers should not be turned away after appropriate due diligence reveals their compliance with laws.[10] Nonetheless, it is clear that the official position of the prudential regulators is not being followed in fact. Instead banks are being "encouraged" to sever their relationships with all payday lenders. A number of CFSA members have been directly affected, and have lost their banking relationships, despite the fact that they are operating legally, with a license, and in compliance of all state and federal laws and have had a long-term relationship with the banks. This outcome has significant negative consequences for both the payday lending industry and the customers who they serve.

Attachment J contains a list of some of the banking institutions that CFSA has learned have severed their relationships with payday lenders. This list is not an exhaustive list of all banks affected by Operation Choke Point, since it is our understanding that many other industries and participants in the nonbank financial services industry have likewise had their banking and ACH relationships terminated.

Below are several direct examples of CFSA member companies who have been negatively affected by Operation Choke Point. Some of the examples do not identify the CFSA member by name out of respect for the company's understandable fear of additional adverse consequences.

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[9] FDIC Financial Institution Letter, FIL-43-2013, *Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities*, September 27, 2013 available at http://www.fdic.gov/news/news/financial/2013/fil13043.pdf

[10] *See* Comptroller Thomas J. Curry, Comments Before the Association of Certified Anti-Money Laundering Specialists (March 17, 2014). ("You shouldn't feel that you can't bank a customer just because they fall into a category that on its face appears to carry an elevated level of risk. Higher-risk categories of customers call for stronger risk management and controls, not a strategy of total avoidance. Obviously, if the risk posed by a business or an individual is too great to be managed successfully, then you have to turn that customer away. But you should only make those decisions after appropriate due diligence.") Available at http://www.occ.gov/news-issuances/speeches/2014/pub-speech-2014-39.pdf

Example 1 – Check Into Cash

Creditcorp (Check Into Cash) has had a longstanding relationship with a number of large national, regional and community banks. Until last year, the company maintained a syndicated credit facility comprised of approximately six banks. It also maintained depository services, bank branch services and other banking services with many banks throughout the country.

Bank of America – Check Into Cash did business with Bank of America for 20 years and used over 250 of their bank branches. On March 19, 2013, Bank of America informed Check Into Cash it would not renew its loan credit commitment when Check Into Cash's bank credit facility expired in 2015. During the March 19 discussion, the Bank of America representative indicated that this was only a credit decision and it did not impact Check Into Cash's treasury relationship utilizing its bank branches and other services. Later in the year, however, Check Into Cash received a letter dated October 30, 2013 stating that Bank of America was terminating all banking services.

JP Morgan Chase & Co - On September 25, 2013, a representative contacted Check Into Cash stating that it too was terminating their banking relationship. The company received a letter dated November 12, 2013 confirming the bank's decision to close their accounts. The company had conducted business with JP Morgan Chase for 16 years.

Fifth Third Bank – Check Into Cash conducted business with Fifth Third for 19 years. The bank had been in Check Into Cash's bank credit facility. Check Into Cash banks with its branches and utilizes other banking services. Most recently, Fifth Third has been testing its safe recycler product in approximately 20 of the Check Into Cash locations, with plans to expand this to other centers. The bank also has been promoting the recycler program as treasury solution for Check Into Cash centers and a significant opportunity to expand the relationship with it. On March 5, 2014, Check Into Cash received a letter stating that Fifth Third Bank would be terminating the relationship.

All three of these banks indicated that the reason for closing the accounts was tied to payday lending. Since the company provides various other financial services such as short term installment loans, title loans, check cashing, etc., it asked if subsidiaries offering loans and services other than payday loans could continue to do business with the banks. The response was that as long as any subsidiary of the parent company offered payday loans, the bank would not conduct business with any member of the consolidated group. Check Into Cash asked one of the banks if it was continuing to provide banking services to companies that offer title loans and do not have payday business, and the response was affirmative. The representative indicated that the bank's decision was based on the payday loan offering.

Example 2- CFSA Member Company A

The CFSA member company operates in 28 states, with over 1200 storefront locations. Among the products offered are payday advances, check cashing, installment loans, and title loans. The company had banking services terminated by four different banking institutions since December 2013 with very little reason provided.

BBVA Compass Bancshares – The bank terminated its relationship in December 2013. The company was told by the bank that they are no longer servicing the payday lending industry, providing no other specific reasons. This affected retail storefront accounts.

Bank of America- The bank terminated its relationship in December 2013. The company was told by the bank that it was ceasing to do business with the industry to avoid reputational risk and compliance issues, but it provided no more specific reasons. This affected retail storefront accounts.

JP Morgan Chase and Co – The bank terminated its relationship in February 2014. The CFSA member was told by the bank that it was ceasing to do business with the industry to avoid reputational risk and compliance issues, but provided no more specific reasons. This affected retail storefront accounts.

Fifth Third Bank – The bank terminated its relationship in March 2014. The CFSA member was told by the bank that it was ceasing to do business with the industry to avoid reputational risk and compliance issues, but provided no more specific reasons. The termination affected corporate accounts, retail storefront accounts, centralized returns, and the company's ACH processor.

Bank of California/ORCC – In September 2013, the company was informed by its card processing company that it could not continue to service payday lenders due to the unwillingness of its bank.

There are several additional examples of card processors declining to, or being unable to participate in requests for proposals due to either the card processor's or its partner bank's unwillingness to work with a company that operates in or does business with the payday lending industry.

Example 3- CFSA Member Company B

The CFSA member company is a lender for over 750 storefront locations. It has had two different banks terminate business relationships.

PNC Bank – The CFSA member has had 18 accounts terminated, with no specific reason provided for the termination. The bank just indicated that it was industry-related; no letter was provided.

Huntington Bank – The CFSA member has had 38 accounts terminated, with no specific reason provided for the termination. The bank just indicated that it was industry-related; no letter was provided. The company was only given 30 days' notice before the termination became effective.

The member company strongly believes that the termination was due to Operation Choke Point. It stated that it has been difficult on the company, but even more difficult on the customer because the company has had to use banks that are not within a close proximity to stores. Therefore, if the customer needs to cash the check, it becomes more difficult to find a bank location.

Example 4- CFSA Member Company C

A CFSA member company received terminations by five different banks in just one month this year. Each bank independently informed the member that the service terminations

were due to the result of pressure from its prudential regulator on the basis of reputational risk associated with the payday loan industry. The banks, Synovus Bank, Fifth Third Bank, Hancock Bank, Whitney Bank, and Umpqua Bank, had provided critical treasury management banking services to the member. The CFSA member had enjoyed good, long-standing business relationships with all of the banks. Three of the bank relationships had been in place for well over a decade.

The CFSA member's operations, performance and compliance programs had been more than satisfactory to these banks and the member had been in continuous communication with its banks about the reported heightened regulatory scrutiny of bank relationships with payday lenders. The member was surprised by the notices of termination since it had actually received assurances from two of the banks that, as one bank stated, "We were doing everything right."

This member depended on treasury management banks for access to payment, deposits, and ACH systems and networks, payroll processing, and other commercial treasury services. The terminations of these relationships disrupted the member's provision of credit and other services to consumers. The CFSA member believes it is clear that in accordance with Operation Choke Point, the prudential regulators are pressuring banks to terminate payday lenders' access to the banking system. Furthermore, it believes that regulators are not differentiating between those who operate in accordance with the law and those who do not.

Example 5- CFSA Member Company D

This CFSA member operates in seven states, with approximately 50 storefront locations. The products it offers include payday advance loans and check cashing. Its banking relationships were terminated by two different banking institutions in 2014 with very little reason provided.

Fifth Third Bank- The CFSA member had over a decade of business relationships which accounted for approximately $250,000 a year. It received a termination letter from Fifth Third earlier this year that stated that "services provided by clients in this industry are outside of our risk tolerance." This termination affected nearly 30 bank accounts. The member has not been provided additional information or a further rationale for the termination.

Wells Fargo- The CFSA member had a long-time business relationship with Wells Fargo. It received termination letters from the bank earlier this year that terminated three different accounts, both deposit accounts and treasury management (ACH origination) services of those accounts. In a letter, the bank's explanation for termination was,

> Wells Fargo performs ongoing reviews of its account relationships in connection with the Bank's responsibilities to oversee its banking operations. After careful review, a business decision has been made to close your account(s) referenced above and terminate all related Treasury Management services (e.g. ACH origination services) associated with the above accounts.

The member has not been provided additional information or a further rationale. The member has clearly suffered financial burden by having to locate new banking institutions that can and will provide the services it needs.

Example 6 – CFSA Member Company E

Bank of America – The CFSA member lost its clearing and currency funding banking relationship with Bank of America. This covered 90 percent of its U.S. store network. The member's relationship with Bank of America originated with the founding of the company in the late 1990s. The member was given no advance notice, and the letter it received provided 90 days-notice.

Example 7 -CFSA Member Company F

Bank of America - In late November 2013, Bank of America notified this member that it would cease to conduct business with any payday lenders as of December 31, 2013. Since January, Bank of America has closed the company's accounts and they are currently operating without local banking because they have been refused service by several financial institutions

Example 8 – CFSA Member Company G

Bank of America – The CFSA Member had a long standing relationship with Bank of America, which was recently terminated. The member was told by Bank of America that it was no longer going to work with payday lenders because of compliance concerns. This member primarily offers installment loans and title loans, a fact that was shared with Bank of America. Bank of America still insisted on ending the banking relationship. Furthermore, it also closed an operating account with a management entity that does not, and never has, offered any loan products.

Example 9 – CFSA Member Company H

Bank of America – The CFSA member company was given verbal notification two-months ago that Bank of America was "exiting the payday advance business," and would be closing its nine business checking accounts sometime in the next three to six months. The CFSA member has had difficulty finding another bank to take over the nine accounts.

Example 10 – CFSA Member Company I

Huntington National Bank – The CFSA member company received a termination notice in May 2013. The member was told by the bank that they could not, "further discuss why Huntington has chosen to dissolve all banking relationships with payday lenders." However, the CFSA member believes it was related to Operation Choke Point.

These are just a sample of the statements and testimonials that CFSA has learned from its membership and others in the payday lending industry. CFSA continues to learn of more ACH and bank terminations each week.

V. Capitol Hill Interest

In January 2014, the Chairman of the House Committee on Oversight and Government Reform, Darrell Issa, sent a letter to Attorney General Eric Holder expressing concerns about whether the DOJ is targeting businesses that are in compliance with applicable laws – such as online payday lenders – rather than actual fraudsters or scammers. Furthermore, Chairman Issa has communicated his interest in holding a hearing in the Committee on Oversight and Government Reform to address some

of the questionable tactics of the coordinating agencies (See Attachment K). However, on February 13, a group of Democratic lawmakers urged the DOJ to continue oversight of the payday lending industry. Senator Jeff Merkley and Representative Elijah Cummings, along with 11 additional Members of Congress, sent a letter to Attorney General Eric Holder requesting that the DOJ continue to, "Crack down on banks and third-party payment processors that facilitate financial scams and predatory payday lending."[11]

In March 2014, during a Senate Banking Committee hearing Sen. David Vitter and others discussed Operation Choke Point. Senator Vitter stated,

> "...I am very concerned that this has expanded to an overall effort to shut down that entire industry, whether folks are following the rules or not and I have heard many documented examples of that, that really raise my concern...I've talked to a number of banks who've said their regulators are coming in and telling them not service folks in that sector."[12]

Further, Senator Vitter submitted emails from banks to customers terminating relationships, one of which stated that their only issue was the "space within you operate" (See Attachment L for more information about discussion of Operation Choke Point in Congressional hearings).[13]

VI. Conclusion

CFSA is extremely concerned about the adverse consumer and business impacts of Operation Choke Point. The association promotes laws and regulations that protect consumers while peserving their access to responsible credit options. CFSA supports and encourage responsible payday advance industry practices. We believe that consumers who want and need the payday lending product are being denied the right to choose their own financial service products based on their individual circumstances. A national public opinion survey conducted by Harris Interactive found that the great majority of borrowers feel that payday loans offered by regulated, lawfully operated storefront lenders are an important and valuable credit option that helps them overcome financial shortfalls, with 95 percent of those surveyed saying they value the option of taking out a payday loan (See Attachment M for the new national survey conducted by Harris Interactive about consumer demand for the payday lending product).

We are also concerned that Operation Choke Point facilitates federal agency actions that are unwarranted and unjustified. Going forward, it is imperative that every effort should be made to differentiate fraudulent actors from legitimate, law-abiding businesses such as CFSA's members.

As CFSA explained in a letter to FDIC Chairman Gruenberg, broad regulatory actions that have the effect of limiting available banking services hurt both consumers and the small businesses that offer them short-term, small-dollar credit products. This is extremely problematic for many consumers

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[11] Senator Jeff Merkley Press Release, *Bicameral Group of Members Urge DOJ to Crack Down on Consumer Scams*, Feb. 26, 2014, available at http://www.merkley.senate.gov/newsroom/press/release/?id=b3e03840-962a-493b-97a9-6a58a5866b01

[12] United States Senate Banking Committee, *Are Alternative Financial Products Serving Consumers?* Hearing, March 26. 2014, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=3fdcfbbe-9681-4a6d-83e5-5d1ace44289c

[13] *Id.*

who already must deal with a tight economy and constricted credit market (See attachment N for CFSA letter to the FDIC).

CFSA asks that Congress fully examine the implications of Operation Choke Point for payday lenders, consumers and federal policy. It is essential that payday lenders are given notice of laws, regulations, and other federal mandates that affect their right to operate a legally compliant business. The over 19 million consumers who want and need short-term, small-dollar loan products, and our member companies and their hundreds of thousands of employees, must be free to choose to participate in a transparent marketplace that supports the entire spectrum of credit needs.

CFSA respectfully requests that the Congress seek assurances from the federal agencies involved in Operation Choke Point that examiners have not been instructed to pressure banks, and that it is not the goal of the DOJ, FDIC, OCC, or other federal agencies, to explicitly or implicitly require banks to sever relationships with payday lenders and other businesses that are in compliance with all applicable laws.

The experience of CFSA's members suggests that Operation Choke Point is resulting in termination of a substantial number of banking relationships with payday lenders. We ask that Congress take all appropriate action with respect to Operation Choke Point to remedy this unfortunate situation.

Regulation of the payday lending industry should proceed with all due process, notice and opportunity for comment accorded other regulation. The Dodd-Frank Act mandated no less. Regulation should be transparent, not carried out in secret, with back room pressure exerted on financial institutions in order to thwart the operations of a lawful industry and the customers that it serves.

Community Financial Services Association of America
Statement for the Record
House Financial Services Committee
"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

Attachments

April 8, 2014

Attachment A – CFSA's Best Practices

Attachment B – Article- Thomas Vartanian, *How Many Bank Supervisors Do We Need?*

Attachment C – Article- William Issac, *DOJ's 'Operation Choke Point': An Attack on Market Economy*

Attachment D – Article - Alan Zibel and Brent Kendall, *Probe Turns Up Heat on Banks*

Attachment E – Article - Kevin Wack, *Fed, OCC Get Flak from Capitol Hill over Targeting of Online Lending*

Attachment F – PowerPoint - Michael Benardo, Joel Sweet, Jennifer LaRoche, *Third Party Payment Processors: Relationships, Guidance, and Case Examples*

Attachment G – Summary - Federal Regulatory Authority for Payday Lending.

Attachment H – Letter to FDIC/DOJ from 31 Members of Congress

Attachment I – FDIC Guidance from Sep. 27, 2013, Clarifying its Policy and Supervisory Approach Related to Payment Processing Relationships with Merchant Customers.

Attachment J – Banking Institutions that have Severed Relationships with Payday Lenders

Attachment K – Chairman Issa Letter to DOJ

Attachment L – Congressional Testimony on Operation Choke Point During Hearings

Attachment M – Harris Poll Summary

Attachment N – CFSA Letter to FDIC

Attachment O – CFSA Letter to CSBS re: ACH

Attachment P – Other Relevant Articles

CommunityChoice FINANCIAL

William E. Saunders
Chief Executive Officer
Direct Dial: (614) 760-2665
Email: tsaunders@ccfi.com

April 2, 2014

The Honorable Jeb Hensarling, Chairman
Financial Service Committee
House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Re: The Committee's Request for Comments Concerning the Consumer Financial Protection Bureau ("CFPB")

Dear Chairman Hensarling:

Thank you for the opportunity to submit these comments. I am the Chief Executive Officer of a business with over 3,200 associates that provides retail financial services to working-class Americans. We have grown from humble beginning, starting more than 20-years ago with a few retail locations in Central Ohio and a relationship with one state chartered bank, a relationship that continued until we received a recent and unexpected notice of its termination a few weeks ago.

From our humble beginning, Community Choice Financial Inc. ("CCFI") has grown to operating 516 retail locations in 15 states as of the end of FY 2013. In addition, CCFI has an internet presence, which provides services to consumers across 24 states. In FY 2013 CCFI generated $439 million in revenue. During the year it cashed $2.8 billion in checks and provided over $2 billion in short-term consumer loans. CCFI is a registrant with the Securities and Exchange Commission and has $395 million in publicly traded bonds. CCFI's subsidiary companies are state-licensed and regulated and CCFI has made a considerable investment in systems that ensure compliance with both state and federal laws.

As noted above, CCFI has enjoyed long-standing relationships with banks and a number of payment processors over its 20-year lifespan. A standard element of these relationships included such institutions conducting periodic reviews of CCFI's compliance systems and procedures so that they were confident of sound compliance and business practices. Regardless of their level of confidence in CCFI, these banks and payment processors have informed us that they have been forced to terminate their relationship with us. While always prefaced with the bank's or processor's expressed desire to continue the relationship and complements about our robust compliance systems, the reasons for termination have ranged from, "we are exiting the small dollar lending space in total," to "we cannot work with internet lending operations," to "our regulators have informed us we need to exit." The official explanations are often opaque, followed by personal communication regarding regulatory pressure related to banks and payment processors providing services to small-dollar, short-term lenders and the forced institution-wide decision to end the relationship with all similar lenders.

As you have correctly recognized this excessive and unprecedented regulatory campaign aims to impair the economic freedoms of legitimate, law-abiding businesses. Its impact is so tangible that in CCFI's recent Annual Report on form 10-K filed with the Securities and Exchange Commission on March 28,

2014, we felt compelled to include bank relationship discontinuance as a stated business risk factor. As you can well imagine, if allowed to proceed to the extreme, it will move from a risk factor to a death-knell.

What follows is a chronology of some of CCFI's experiences:

Banks

Bank of Kentucky

CCFI's relationship with Bank of Kentucky dates back to 2009. Bank of Kentucky previously provided a revolving credit facility and treasury services including: employee health savings account management, returned check consolidation, and depository services. Our relationship with Bank of Kentucky was formed in 2009 and was in very good standing. In ***August of 2013***, citing "regulatory directives," Bank of Kentucky informed us that they could no longer continue to provide the majority of these services. Since that time Bank of Kentucky terminated treasury managements services and informed us that they would not renew the existing revolving credit facility.

Bank of America

CCFI's relationship with with Bank of America dated back more than ten years. Bank of America previously provided treasury management services. In ***November of 2013***, citing "pressure" about reputational risk from their regulators, Bank of America informed us that they would need to terminate the existing relationship.

Fifth/Third Bank

After a more than 20-year banking relationship, in ***December of 2013***, Fifth/Third Bank abruptly stopped opening new accounts and informed us that they were "working with its regulators to evaluate our industry." Fifth/Third's long-standing relationship with CCFI included playing a lead role in our recapitalization in 2011, a leading role in our revolving credit facility and participation in our bond offering. In addition, Fifth/Third was our leading treasury management service provider, provided merchant processing services and worked with us to launch a new "smart safe" technology, which we planned to deploy in nearly all of our retail locations. On ***March 5, 2014***, CCFI received formal notice that Fifth/Third had determined that "the services provided by clients in [the payday loan] industry are outside of [Fifth/Third's] risk tolerance." This notification included Fifth/Third's intention to terminate the relationship by June 30, 2014.

US Bank

US Bank successfully competed for a portion of CCFI's treasury management business in response to a Request for Proposal in November 2009, which initiated US Bank's provision of concentration, depository and disbursement accounts. As a normal extension of these services,

in ***mid-2013***, CCFI requested the addition of certain automated clearinghouse or ACH services. In order to mitigate any perceived credit risk, CCFI offered to pre-fund transactions, but citing similar regulatory concerns, US Bank has been unable to add these services or to expand the relationship.

Payment Processors

Billing Tree

CCFI's merchant processing relationship with Billing Tree dates back to 2009, and included PIN-based debit terminals in approximately 400 retail locations and online virtual terminals. In ***August 2013*** Billing Tree discontinued our access to this payment processing network because of a directive from their processor, Global Processing, whose sponsoring bank was HSBC.

Triangle Merchant Processing

In response to the loss of the Billing Tree relationship, approximately 150 of our retail locations in Indiana, Michigan, Arizona, Florida, Kansas, Missouri, and Illinois moved their payment processing to Triangle Merchant Processing ("Triangle") in the fall of 2013. However, in ***December of 2013***, we were notified by Triangle that its sponsor bank, Wells Fargo, required that Triangle terminate the relationship.

2C

Also in response to the loss of the Billing Tree relationship, the PIN-based debit terminal merchant processing of another 150 of our retail locations (those in Ohio, Kentucky, Utah and Virginia, 2C Merchant Processing PIN Debit Terminals and virtual terminals for California, Virginia and Utah, were moved to 2C in September-October 2013. Shortly thereafter in ***November of 2013***, citing its sponsor bank, Wells Fargo, as the reason, 2C notified us it would have to terminate any payment processing through Wells Fargo.

Orion

CCFI enjoyed a long standing relationship with Orion which provided PIN-based debit terminals in all of the Alabama retail operations. In ***December of 2013***, citing its sponsor bank, Wells Fargo, as the reason, Orion notified us it would have to terminate any payment processing through Wells Fargo.

Although there is nothing unlawful about CCFI's short-term, small-dollar or payday loan products, various federal agencies have attacked these and certain banks' "deposit advance" products (such as Fifth Third Bank's early access program or Wells Fargo's deposit advance program) and forced these banks to discontinue offering those products. Furthermore, we applaud protecting consumers from unscrupulous practices, by unlicensed, unregulated and/or off-shore lenders, by attacking their access to the banking system but we are appalled this effort is being used to substantially reduced access to those payment channels for licensed, regulated, domestic lenders.

The natural consequence of these attacks is what you see chronicled above: banks have become increasingly frightened about retaliation from their regulators deriving from any form of banking relationship with companies, such as ours, that offer payday loan products. In an Orwellian fashion, these federal regulators are exercising power so as to carry out a political agenda, not the enforcement of properly adopted statutes or regulations. The effect of this political crusade is a material interference with the relationships between licensed, regulated, taxpaying businesses and their banks. The consequence, likely intended by these federal regulators, is to stifle the expansion of businesses like that of CCFI.

There should be no doubt: Consumer protection is important and bad actors should be penalized. Assuming universal agreement on this premise, one cannot help but wonder why the various federal regulators have focused so much attention on providers of legitimate, state-licensed financial products.

In closing, again I am grateful that you have recognized the need to protect us from gross infringement by federal regulators on the very economic freedoms upon which this great nation was built. If I can provide greater insight into any of the points addressed herein I would be pleased to do so.

Yours very truly,

William E. Saunders, Jr.

CUNA
Credit Union National Association

Bill Cheney
President & CEO

601 Pennsylvania Ave., NW
South Building, Suite 600
Washington D.C. 20004-2601

Phone: 202-508-6745
Fax: 202-638-7734
bcheney@cuna.coop

April 2, 2014

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

On behalf of the Credit Union National Association (CUNA), I am writing to thank you for scheduling the hearing next Tuesday entitled, "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom." CUNA is the largest credit union advocacy organization in the United States, representing America's state and federally chartered credit unions and their 99 million members. We appreciate the opportunity to submit this letter for the record of the hearing.

As you know, credit unions' statutory mission is to promote thrift and provide access to credit for provident purposes. By all accounts, credit unions are achieving this mission. However, the ever-increasing regulatory burden that credit unions face makes this more difficult. This crisis of creeping complexity has contributed to consolidation in the financial services industry and a reduction in the availability of services to consumers and small businesses. Credit unions have not been immune from this unfortunate phenomenon. New and frequently changing regulations drive costs up for credit unions and their members, making matters worse.

It is hard to see how credit union members are well served by regulations like the Consumer Financial Protection Bureau's (CFPB) remittances rule, which caused some credit unions to exit the business, or the CFPB's various mortgage rules, which have increased the time it takes and the cost of providing mortgage credit or why Congress did not more explicitly direct the CFPB to impose such rules only on abusers. Therefore, it is understandable that credit unions are anxious about the next round of consumer regulation because of its potential impact on their ability to offer affordable financial services to their members.

CFPB rules should target the bad actors in the financial services market, not force out the good actors. That is why we have consistently urged the CFPB to exempt credit unions from their rulemakings, unless there is a record of abusive practices by credit unions on the issue being addressed. The Dodd-Frank Act and other provisions allow the CFPB to take such action. Moreover, credit unions should be exempt from these rules because their structure militates against predatory and abusive practices, and their history of member service bears that out. Credit unions have always treated their members well because the members are also the owners of the credit union; a credit union cannot exist without its members. While we appreciate the efforts that the CFPB undertakes to listen to the concerns of credit unions during the development of its rules, we continue to be disappointed that the CFPB has not used its exemption authority more extensively. We hope the Committee will direct the CFPB to exercise this authority.

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The Honorable Maxine Waters
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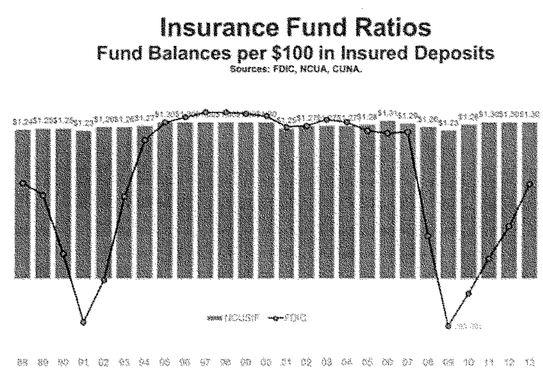
As we look at the current environment with respect to potential regulatory burden, credit unions are most concerned with the National Credit Union Administration's (NCUA) recently proposed risk-based capital rule because it is fundamentally flawed and if implemented as proposed, would significantly reduce credit unions' ability to lend and provide other important services to their members. The comment period for this proposed rule remains open, and CUNA will be submitting its comments in the near future. However, we believe it is critically important for the Committee to thoroughly examine this proposal and its potential implications on credit unions' ability to serve their members. NCUA Chairman Matz and the other members of the NCUA Board have indicated a willingness to consider changes to the proposal; we appreciate their willingness to accept feedback and believe this enhances the importance of this Committee's scrutiny of the proposal.

The proposed rule ignores the historically solid performance of existing capital standards. It would create an artificial shortfall of as much as $7.3 billion in capital at covered credit unions through the imposition of asset risk-weightings that are poorly calibrated and in some cases more stringent than the Basel III risk-weights to which small banks are subject. Further, we believe the proposed rule exceeds NCUA's authority under the Federal Credit Union Act and its 18-month implementation period is unreasonable when compared to the very generous amount of time banking regulators afforded small banks to comply with similar, but less stringent standards. It is, very simply, a solution in search of a problem.

The purpose of capital standards and a system of prompt corrective action (PCA) is to minimize losses to the deposit insurance fund. As the chart below describes, while the FDIC fund became technically insolvent during each of the last two financial crises, the National Credit Union Share Insurance Fund (NCUSIF) has performed very well, under current PCA rules.



This suggests that the PCA system protecting the share insurance fund does not need to be strengthened, and raises the question of why NCUA is pursuing this rule at this time. It is an important question for Congress to ask given the fact that the proposed rule would require credit unions to raise billions in superfluous capital in order to maintain the same proportion of capital buffers they currently have. Because most credit unions do not have access to supplemental forms of capital, raising this amount of capital through retained earnings alone would be challenging.

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To comply with the proposed rule and maintain their capital buffers, credit unions would be forced to realign their books, reducing assets deemed 'risky' by the rule, and reduce credit availability, particularly mortgages and business loans which are assigned inappropriately high risk-weights. Because the proposed rule includes poorly designed risk-weights – some of which are more stringent than comparable risk-weights under the Basel regime for small banks – the proposed rule would have a significant adverse impact on credit unions' ability to serve their members.

With the exception of consumer loans, the proposed rule's risk-weights are the same as or higher than risk weights applied to community banks under Basel III. In two important cases – residential mortgage loans and member business loans – the risk-weights in some situations would be double the comparable Basel weights, despite the fact that for these two categories of loans, credit union losses trend at about half the loss rates of small banks. This would deter the provision of mortgage and business loans to credit union members.

Comparing Small Bank Basel and the NCUA Risk Based Capital Proposal		
Aspect	**Small Bank Basel Risk Weights**	**NCUA RBC Proposed Rule Risk Weights**
Residential Mortgage Loans	50% (regardless of concentration)	50% (0% - 25% of assets) 75% (25% - 35% of assets) 100% (35% and above of assets)
Small Business Loans	100% (regardless of concentration)	100% (0% - 15% of assets) 150% (15% - 25% of assets) 200% (25% and above of assets)

The impact of the proposed rule would be particularly damaging to rural and low-income areas because there are several credit unions in these areas which have higher concentrations in agricultural and business lending. They are either exempt from the member business cap because of their historic concentration in business lending or because they are a low-income designated credit union. The rule increases the risk-weight of these types of loans as the credit unions' concentration in them increases.

We are also troubled because the proposed rule appears in several respects to be inconsistent with NCUA's authority and responsibility under the law. For example, the Federal Credit Union Act requires NCUA to establish a risk-based capital system to take into account any material risks for which the net worth ratio at the adequately capitalized level may not provide adequate protection. However, the law does not direct NCUA to peg the standard to the well-capitalized level, as the proposed rule would do.

Further, NCUA is required under the Federal Credit Union Act to take into consideration the unique structure of credit unions when implementing its risk-based net worth rule. We do not believe that NCUA has fulfilled this responsibility because the risk-weightings in the proposed rule are more stringent than the Basel risk-weightings for small banks. Credit union loss rates on comparable loan types are typically lower than at small banks; the structure and performance of credit unions suggests the risk weights should be less stringent.

In addition, NCUA would redefine "complex" credit unions that are subject to the rule as those with over $50 million in assets, despite the fact that the Federal Credit Union Act clearly directs NCUA to consider the portfolios of credit unions' assets and liabilities in determining which credit unions meet the definition, not asset size alone.

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Finally, the implementation period in the proposed rule is unreasonably short and would unduly burden credit unions. NCUA proposes to implement the proposed rule 18 months after it has been finalized. In contrast, small banks will have had nearly nine years to implement the Basel capital standards from the time they were first developed in 2010 until the time they will finally be implemented in 2019. Eighteen months is simply not enough time for credit unions to make the changes necessary to be in compliance, especially in the absence of authority to raise supplemental forms of capital other than retained earnings.

The proposed rule represents one of the most severe threats to credit unions' ability to continue to fulfill their statutory mission because it would do little to enhance the safety and soundness of credit unions, but it would significantly constrain credit unions' ability to meet the financial services needs of their members. Noting the concern that many members of the Committee demonstrated during the consideration of similar, and in many ways less stringent, capital rules for small banks, we encourage the Committee to thoroughly examine this proposed rule and direct NCUA to make significant changes to address the serious deficiencies addressed in this statement.

On behalf of America's credit unions and their 99 million members, thank you very much for holding this hearing and considering our views.

Best regards,

Bill Cheney
President & CEO

Statement for the Record

of

THE ELECTRONIC TRANSACTIONS ASSOCIATION

United States House of Representatives

Committee on Financial Services

Hearing on:

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

April 8, 2014

Chairman Hensarling, Ranking Member Waters and Members of the Committee, the Electronic Transactions Association ("ETA") appreciates the opportunity to submit this statement for the record for the Committee's hearing, "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

ETA is an international trade association representing companies that offer electronic transaction processing products and services. The purpose of ETA is to help the merchant acquiring industry by providing leadership through education, advocacy, and the exchange of information. ETA's membership spans the breadth of the payments industry, from financial institutions and transaction processors to independent sales organizations ("ISOs"), equipment suppliers, and merchants. More than 500 companies worldwide are members of ETA.

ETA recognizes the vital role well-considered and prudently enforced federal laws and regulations can play in fostering and protecting a competitive and innovative marketplace. In particular, federal agencies help uphold contract law and the operation of free markets with their efforts to fight fraud. As the trade association for the payments industry, ETA fully supports federal efforts to combat fraudulent and other illegal activities. These efforts benefit both consumers and the payments industry. After all, consumers will be far less likely to avail themselves of the benefits of electronic payments, like faster and more convenient payment methods, if they believe that payments systems could expose them to fraudulent schemes. Accordingly, ETA believes that the payments industry, financial regulators, and law enforcement have a mutual interest in preventing the use of payment systems to perpetrate fraud and other illegal activities.

ETA maintains that the payments industry is well-positioned to help the federal government advance this mutual interest in preventing harm to consumers and protecting the payments system. For its part, ETA is leading efforts to help the credit and debit card processing industry identify fraudulent merchants and prohibit their access to payments system. Unfortunately, recent initiatives by the Department of Justice ("DOJ") and the Federal financial regulators threaten to stifle ETA and other industry efforts with excessive regulation and one-size-fits-all litigation, which cannot possibility include the flexibility and adaptability that banks and non-bank processors need in underwriting and monitoring merchant accounts.

The payments industry has a remarkable record of success in preventing the use of payments systems for illegal activities. Over the past two decades the payments industry, and the online commerce it helps fuel, have experienced unprecedented growth. In just two decades the amount of online commerce has grown from approximately $5 billion to more than $263 billion today. While this revolution in technology and business has benefited consumers with lower prices and new goods and services (including better payment options), it has also created new opportunities for unlawful activity. The payments industry has responded to these risks with substantial investments in new tools and practices aimed at identifying and thwarting the use of payment systems by criminals. These investments have proven to be remarkably successful. Currently, the rate of fraud on payments systems is less than one-tenth of one percent of the more than $5 trillion in payments processed. Consumers are protected by card issuer "zero liability" policies and have no financial responsibility for such fraud. Even with this success, the payments industry is continually updating its technologies to allow it to stay ahead of criminal enterprises and protect consumers from harm.

Despite the payments industry's record of success in fighting fraud and other illegal activities, the Financial Fraud Enforcement Taskforce, led by the DOJ and federal financial regulators, has recently undertaken a new initiative, "Operation Choke Point," which targets the payments industry. This initiative aims to impose liability on payment systems for the illegal activities of merchants that involve use of the payments system. ETA believes that this approach is misguided. Rather than targeting criminal enterprises directly, Operation Choke Point paradoxically takes aim at payment systems that are actively fighting fraud on their networks. Instead of viewing payment systems as allies in the effort to protect consumers, the DOJ and federal financial regulators have sought to impose liability and costly regulations on them. This adversarial approach toward the payments industry has the potential for unfairly imposing liability on payment processors for the acts of unscrupulous merchants even when a payment processor did not know or consciously avoid knowing about the fraud. It also diverts resources and attention the payments industry could otherwise deploy to help stop fraud to instead respond to costly and time-consuming investigations and litigation by multiple regulators. As a result, the federal government and the payments industry spend more time focused on each other, rather than pursuing their common goal of protecting consumers from fraud. A more sensible policy would be for the federal government to step back from its aggressive stance toward payment systems, recognize the strong interest the payments industry has in preventing fraud and other illegal activities, and allow the industry to focus on enhancing its underwriting and risk management tools to safeguard the payments system from unscrupulous merchants.

The broad reach of Operation Choke Point has also created several other serious problems. First, the DOJ has advanced a legal theory that would impose broad liability on the payments industry, which has had a chilling effect on the willingness of payment systems to do business with small and innovative merchants, especially start-up firms. Using a controversial interpretation of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), DOJ has sought to hold financial institutions liable for the fraudulent activities committed by other participants in the payments system that affect federally insured financial institutions. Because FIRREA has a 10 year statute of limitations, and requires only that the DOJ prove its case by "a preponderance of the evidence," the mere prospect of a civil action under FIRREA has been sufficient to cause law-abiding financial institutions to allow only established, low-risk companies access to their services.

Second, the costly and complex compliance programs the DOJ and federal financial regulators seek to impose on payment systems will likely further increase the likelihood that law-abiding companies and person will have their access to the financial system restricted. For example, the well-publicized effort to require that payment processors restrict access to their systems if a merchant has a return rate of 3 percent or more threatens many merchants whose business models involve high rates of returns, such as Internet-based clothing merchants. Although well-established companies will be able to satisfy a subsequent review by a payment processor that it is not engaged in illegal activities, the expense of conducting such a review for new and small companies will likely be too burdensome, causing payment systems to halt processing their payments. While thwarting fraud and illegal activities is a critical goal, it must be balanced against ensuring that law-abiding companies can still access the payments system. Moreover, given the complexities of providing services to businesses of all sizes, types, sales

volumes, and other factors, underwriting and risk monitoring of merchants must be allowed flexibility and adaptability, which a one-size-fits all law will not allow.

Third, the aggressive enforcement stance by the DOJ and financial regulators under Operation Choke Point will ultimately harm consumers. It is consumers who will end up paying the costs of burdensome federal mandates and the increased risk of liability for payment processors. It is consumers who will be harmed when new companies are unable to access the payments system needed to transact purchases. It is consumers who will be incentivized to use less efficient, alternative payment methods. And it is consumers who will be the victims of more fraud if Operation Choke Point undermines the payments industry's anti-fraud efforts. As a result, Operation Choke Point risks harming consumers more than criminals.

Finally, the use of enforcement actions as a substitute for formal rulemaking deprives the public of the opportunity to participate in this important regulatory policy. If federal regulators want to impose new liabilities on payment systems, they should either have to obtain authorization from Congress or issue a rule pursuant to existing authorities in accordance with the Administrative Procedures Act. Policy should be made in a transparent manner, not as part of privately negotiated settlement agreements.

In contrast to the approach adopted by Operation Choke Point, ETA believes that a common sense way to address fraudulent and other illegal activities involving payment systems is to permit the payments industry the flexibility and freedom to continue to develop new technologies and practices to combat financial fraud.

To demonstrate its commitment to devising better practices, ETA recently developed and published its "Guidelines on Merchant and ISO Underwriting and Risk Monitoring" ("Guidelines"). The Guidelines are the core of an educational curriculum designed to provide ETA members with recommended tools for mitigating merchant risk. The Guidelines include such topics as underwriting and risk management of merchants, and the due diligence and oversight of third parties, primarily ISOs. This educational initiative aims to help ETA members eliminate prohibited and undesirable merchants from entering their systems. Rather than impose one-size fits all standards, the ETA's voluntary industry program is designed to supplement existing practices and strategies. Given the rapidly evolving nature of the payments industry, the Guidelines are a "living document" that will be reviewed and updated to reflect future developments in technology and industry practices.

The Guidelines are focused on protecting consumers. They seek not only to protect consumers from disreputable merchants by ensuring that such merchants cannot access payment systems, but also aim to ensure that reputable merchants have reasonable security measures in place. At the same time, the Guidelines seek to ensure that consumers do not lose access to reputable merchants with new or innovative business models that result in higher than normal return levels or trigger other proxies for suspicious activities. In short, the Guidelines provide a well-thought out approach to fighting financial fraud that avoids the adverse consequences to consumers of Operation Choke Point.

The Guidelines also show that the payments industry is able to effectively address fraudulent and illegal activity on their systems, provided it has the freedom to do so, unburdened by an unnecessarily litigation and regulatory mandates. It is ETA's hope that the payments industry will be given the chance to show that the Guidelines, along with the industry's investments in new technology, are up to the task of protecting consumers from financial fraud.

* * *

ETA would like to thank the Committee for this opportunity to provide this statement for the record on this important topic. If you have any questions about this statement or the issues discussed, please contact Scott Talbott, Senior Vice President of ETA at 202 828-2635.

FINANCIAL SERVICE CENTERS OF AMERICA, INC.
A NATIONAL TRADE ASSOCIATION

Statement of

FINANCIAL SERVICE CENTERS OF AMERICA

To the
U. S. House of Representatives
Committee on Financial Services

Regarding
The Impact of Recent Regulator Supervisory and Enforcement Actions on Consumer Financial Services

Washington, D.C.
April 8, 2014

www.fisca.org

1730 M STREET N.W. • SUITE 200 • WASHINGTON, D.C. 20036 • TEL. 202-296-3522 • FAX 202-296-7713

Introduction

Financial Service Centers of America (FiSCA) is pleased to submit this statement to the U.S. House of Representatives Committee on Financial Services (Committee) in connection with the April 8, 2014 hearing to examine the impact of recent regulator supervisory and enforcement actions on consumer financial services. We submit to the Committee that recent supervisory and enforcement actions by the federal bank regulatory agencies, apparently in concert with the Department of Justice, have directly led to an alarming number of banks indiscriminately terminating their relationships with FiSCA member companies. We further submit that these determinations to deny banking services to our members are not being made based upon legitimate, individualized, and appropriate assessments of risk, but are being made based solely on politicized regulatory pressure and informal intimidation related to the products and services being offered by legal, licensed and regulated businesses.

Every business needs a bank account to operate. FiSCA members are no different. Similarly, millions of consumers across the nation rely on FiSCA members for their financial services needs. If these account terminations continue unchecked, bank discontinuance will destroy an entire industry, threatening the delivery of basic financial services in communities across the country and driving otherwise legitimate consumer financial transactions out of the regulated market and into untraceable or underground channels. Contrary to long-established U.S. security objectives, these bank discontinuances will make consumers more vulnerable by forcing them to turn to illegal and unscrupulous predatory providers.

The question posed by the Committee for this hearing is whether bank regulators should be able to dictate which financial products and services can be offered to consumers, not by regulating those products and services directly, but by pressuring their member banks to cut off

access to the banking system by the licensed and regulated businesses that offer them. We submit that the answer is unequivocally no; financial products and services must be appropriately overseen according to statutory authority granted to regulators by Congress. Any attempts by regulators to deny licensed and regulated businesses access to the banking system must be viewed as extra-legal activities, outside the scope of their authority. The actions of these regulators are fundamentally wrong, set a most dangerous precedent regardless of political affiliation, are *ultra vires*, a denial of due process, and ultimately, will most negatively impact precisely those consumers Congress wants to protect.

Despite FDIC and Department of Justice assertions to the contrary, there is ongoing and compounding harm to licensed businesses and, we submit, to insured depository institutions. This regulatory abuse poses an imminent threat to consumers who depend on these services. The only way to halt the impending irreparable harm to our industry and to our customers is for the banking regulators to effect an immediate moratorium on bank discontinuance. During a moratorium, Congress can engage in considered oversight of recent regulatory efforts and their impact on licensed businesses, banks, and consumers. Other measures should be enacted to incent banks to enter, or re-enter this market, and to protect those that do. Finally, federal regulators should work with those non-banks and banks that follow the rules, and take direct, credible action to root out law breakers.

Financial Service Centers of America

FiSCA is a national trade association representing over 5,000 neighborhood financial service center providers throughout the United States. FiSCA's members, referred to as financial service centers (FSCs), provide a range of transactional financial services including check cashing, wire transfers, money orders, bill payment services, payday loans, and other small dollar

loans. Because they provide these services, FiSCA's members are designated as Money Services Businesses (MSBs) under the Bank Secrecy Act (BSA) and USA Patriot Act.

FiSCA's members, which include large chains with hundreds of locations as well as small "mom and pop" establishments throughout the U.S., employ tens of thousands of people and serve millions of customers, both banked and un-banked, who choose to use them because they fit their need for basic financial services, or because they have been denied access to traditional financial institutions. Every year, FSCs conduct more than 350 million transactions, providing more than $106 billion in various products and services to 30 million customers. FSCs serve customers from all walks of life, including urban communities and the under-banked, groups that the federal banking agencies have stressed as being underserved by more traditional financial institutions. The financial service center industry is unquestionably the product of the powerful market forces which have shaped it. It has grown out of a need for convenient, accessible financial services.

The value of MSBs has been recognized time and time again. Former U.S. Treasury Secretary John Snow perhaps characterized it best in 2005, when he stated in an address to the Florida Bankers Association that MSBs "are key components of a healthy financial sector, and it is very important that they have access to banking services." MSBs are very much a part of the fabric of a healthy economy, yet recent bank regulator actions have placed the industry in peril, and its customers at risk.

The FSC industry is highly regulated and significant government oversight of the industry presently exists. MSBs must register with the Financial Crimes Enforcement Network (FinCEN) and are subject to periodic IRS examination. Most states license and regulate MSBs. Every state in which payday lending exists regulates that product. Licensing authorities typically

impose recordkeeping and reporting requirements, and subject licensees to periodic examination by state (often banking department) examiners.

A common misperception regarding MSBs is that they are "high risk" for money laundering and other financial crimes. Quite to the contrary, FSCs are clearly on the frontline in the war on money laundering and other financial crimes. MSBs are required under the USA Patriot Act to have compliance programs, including written anti-money laundering (AML) policies and procedures, compliance officers, training programs and independent compliance examinations. We are required to file Suspicious Activity Report (SARs), Currency Transaction Reports (CTRs), and maintain detailed records of transactions. FiSCA itself is the recognized leader in developing comprehensive BSA/AML compliance materials. Thus, the "high risk" label is a myth, utilized when convenient by banks seeking to exit, or regulators seeking to effect a termination of the business.

Finally, federal regulation of many of the products and services offered by MSBs existed well before the passage of the Dodd-Frank Act, through the Federal consumer financial laws. With the passage of Dodd-Frank, those products and services are within the jurisdiction of the Consumer Financial Protection Bureau (CFPB) and MSBs are subject to CFPB examination, supervision and enforcement.

The Insidious Problem of Bank Discontinuance

In simple terms, bank discontinuance is the indiscriminate termination by banks of the accounts of all members of a particular industry; in this case, MSBs. Like any other business, MSBs cannot operate without access to commercial banking services, including depository accounts, lines of credit, and remote deposit services. Imagine trying to run a business without being able to make deposits or write checks! In fact, regulatory requirements in many states

dictate that MSBs maintain bank accounts and lines of credit. In those states, failure to maintain a bank account or the required line of credit can result in the revocation of a license, or other enforcement actions.

The FSC industry is sound, stable, responsible, licensed, regulated, and profitable. It does not operate underground. No FiSCA member was involved in creating the 2007 or 2008 financial meltdown, nor were FiSCA members' products implicated in the collapse. There is no question that banks are required to expend greater resources in maintaining MSB customer compliance and monitoring systems, however, it has to be assumed that MSBs pay for banking services commensurate with the costs and the profit requirements of the banks that service this market sector.

Over the last year, the industry has experienced an alarming increase in the number of banks making wide-scale terminations of MSB accounts. In most instances, the bank advises that its determination is based on issues caused by increased regulatory pressure from federal bank regulators, not activities in the market. (Attached as Exhibit "A" to our submission are copies of redacted letters from several of the banks that have recently terminated MSB accounts).

Most recently, the regulatory pressure was the result of Operation Choke Point, the effort by federal bank regulators and the Department of Justice to rid the payment system of illegal, on-line payday lenders. Let us be perfectly clear, FiSCA and its members support the stated goals of Operation Choke Point. Illegal operators threaten consumers and legitimate businesses alike. However, Operation Choke Point has become the impetus for termination of the bank accounts of legitimate, licensed businesses, and, as such, is no more legal than the unlicensed operators it seeks to curtail. Regardless of its stated goal, the impact on consumer financial services is

substantial, and it is threatening to curtail or constrain the delivery of licensed financial services to millions of Americans.

Many FiSCA members have provided us with examples of their recent experiences with banks, and these examples can only be described as alarming. (Copies of some of these communications are attached to our submission as Exhibit "B"). In the last week alone, FiSCA has heard from members in the following cities and towns, reporting their bank accounts have been terminated:

- Kawkalin, Michigan
- Tampa, Florida
- Panama City Beach, Florida
- Homestead, Florida
- Jacksonville, Florida
- Kapaa, Hawaii
- Dover, Delaware
- Toledo, Ohio
- North Olmstead, Ohio
- Dublin, Ohio
- Chicago, Illinois
- Irving, Texas
- New York, New York
- Waterbury, Connecticut

Since mid-2013, FiSCA members have had their bank accounts terminated by:

- Fifth Third Bank
- Bank of America
- Bank of Hawaii
- PNC Bank
- GTE Financial
- Wells Fargo Bank, N.A.
- Capital One Bank
- Hancock Bank/Whitney Bank
- US Bank
- Peoples Credit Union

Most of these terminations, which impact thousands of MSB locations, offering a full range of financial products and services, have occurred within the last six months. In many

cases, our members are reporting that banking relationships spanning more than 10 years have been terminated. They report lost business investment, loss of franchise opportunities, and loss of retirement savings. In some instances, the terminating bank will not release funds held as security for up to a year after the termination.

Just a few weeks ago, in mid-March, all of the FiSCA members banking with Fifth Third Bank received a letter advising them that their accounts were being terminated and that they had to be out of the bank by June 30. The letter advised that the decision was based on an "industry review" of the "payday lending industry", and that Fifth Third had determined that the services provided by those customers were "outside of our risk tolerance." (*See* copies of letters from Fifth Third Bank, attached as Exhibit "A"). We submit that the determination by Fifth Third to terminate these companies was indiscriminate, and not made with respect to product mix (in fact, payday lending was a small portion of the business of several of these companies), financial condition, IT systems, legal and compliance systems, management structure, or any other appropriate banking consideration. Rather, the decision was made due to regulator pressure based solely on the products being offered. This conclusion is not ours alone, but that of the Chairman of Fifth Third Bank. (*See* "DOJ's 'Operation Choke Point': An Attack on Market Economy," *American Banker*, March 21, 2014).

In many of the letters and communications that accompany termination decisions, banks point to their conclusion that MSBs present a high risk. Not only do they not define the risk, but their conclusions are unsupported by facts, and, we believe, simply a smokescreen for succumbing to regulator pressure related to the products these companies offer.

In a letter dated February 26, 2014 from Hancock Bank/Whitney Bank to a FiSCA member, the bank stated that its determination to close the account was based on the fact that it

was "unable to effectively manage your Account(s) on a level consistent with the heightened scrutiny required by our regulators for money services businesses due to the transactional characteristics of your business."

In an email from a bank in Texas to a FiSCA member, the Executive Vice President and Manager of the bank explained:

> Based on your performance, there's NO WAY we SHOULDN'T be a credit provider.
> Our only issue is, and it has always been, the space in which you operate.
> It has never been the service you've provided or the way you operate.
> You've obviously done a brilliant job.
> It is the scrutiny that you, AND NOW WE, are under.

(emphasis in original). This admission is refreshingly candid, as most bankers, who find themselves pressured by regulators, are reluctant to identify and explain the real reasons for termination of MSB accounts, most often relying on the amorphous conclusions of "risk" or "business decision" as the basis. (*See* March 3, 2014 letter from Wells Fargo Bank, N.A., and December 6, 2013 letter from Bank of Hawaii, attached as Exhibit "A"). Let us again be clear, nothing has changed in our or their business except the pressure being brought by regulators trying to stop illegal, on-line businesses.

Capital One Bank Exits the New York Market

In New York State, there are some 150 licensed check cashing companies which cash approximately 30 million checks a year, with a total value of $12-$13 billion. The New York industry, which serves almost one million customers, has existed in New York since 1944. Check cashers in New York charge a regulated fee of 1.98% to cash a check. New York's check cashing law also requires that licensees maintain bank accounts and minimum lines of credit to remain in compliance. Earlier this year, Capital One Bank (CapOne), which had been serving approximately 50% of the state's check cashers, announced that it will be terminating all of its

check casher/MSB accounts, beginning on June 1, 2014. As a result, some smaller check cashers, including some multi-generational family businesses, will not find new banks and they will be forced to sell their businesses at depressed prices, or simply close their doors.

With the exiting of CapOne, FiSCA members and the industry in New York at large, are now primarily served by two banks - both of which are from another state. If one or both of those banks should exit the business, the result may be disastrous. Almost a million people who rely on check cashing locations for their financial services, including check cashing, bill payment, rent payment, wire transfers, money orders, and other day to day financial services, will be left without a licensed location at which to conduct their transactions. The need for these transactions will not, however, go away. Customers will be forced instead to go to bars, liquor stores, and other unregulated locations where they will be charged exorbitant fees to conduct their financial transactions. None of those transactions will be within sight of regulatory authorities.

Other areas are experiencing similar trends. The treatment by banks across the country of hard-working business owners is outrageous. In one instance, after an MSB's accounts were closed, the bank closed the personal accounts of the owner's son, a 21 year old college student! In another instance, a FiSCA member closed its check cashing operation altogether since, after being terminated by two banks and being unable to obtain a banking relationship, including the legally required bank account and line of credit, it could not maintain a licensed location without risking a violation of state law. Certainly, the closing of those locations impacts the consumers in the area that relied on that business for their financial services. In some instances where MSBs had long-term relationships with local or regional banks, their accounts terminated when those banks were acquired by larger, national banks.

Finally, of the banks that continue to serve the industry, many are refusing new accounts, or are placing onerous and costly requirements on the accounts they currently maintain. All of these factors together have a potentially disastrous and unjust impact on the industry and, in turn, on its customers.

Neither FDIC Nor DOJ Has Halted the Terminations

Operation Choke Point was initially disclosed in March of 2013. Following its disclosure, on September 17, 2014, FDIC Chairman Martin Gruenberg sent a letter to Congressman Blaine Luetkemeyer explaining that "the majority of transactions passing through financial institutions and payment processors represent legitimate transactions initiated by reputable merchants." The Chairman further stated that "[i]n order to address any confusion about our supervisory approach, we plan to issue a Financial Institution Letter for the banks we supervise to make it clear that the FDIC's focus is the proper management of the banks' relationship with their customers, particularly those engaged in higher risk activities, and not underlying activities that are permissible under state and federal law." (emphasis added).

On September 27, 2013, the FDIC issued a Financial Institution Letter (FIL-43-2013), entitled "FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities" (Guidance). The stated purpose of the FDIC Guidance was to "clarify its policy and supervisory approach related to facilitating payment processing services, directly, or indirectly through a third party, for merchant customers engaged in higher-risk activities," namely on-line short-term lenders. The Guidance provided:

> Facilitating payment processing for merchant customers engaged in higher-risk activities can pose risks to financial institutions and requires due diligence and monitoring, as detailed in prior FDIC and interagency guidance and other information. Financial institutions that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing

> services to customers operating in compliance with applicable federal and state law.

(emphasis added).

The Guidance has failed to halt the terminations. In fact, it appears to FiSCA that the pace of terminations has increased. As set forth above, since mid-2013, FiSCA members have had their accounts terminated by at least ten banks, and many of these terminations occurred after the FDIC Guidance. If anything, last year's FDIC Guidance has merely exacerbated the situation. We believe that many banks view the Guidance as adding to the regulatory pressure that accompanies serving MSBs, and it appears that some banks have terminated their MSBs as a result of the Guidance.

On January 22, 2014, the U.S. Department of Justice (DOJ) issued a letter to the American Bankers Association and the Electronic Transactions Association, purporting to clarify DOJ's policy and approach regarding certain investigations into banks, payment processors, and other institutions that process payments for merchants engaged in fraudulent activities. Relying in part on the FDIC Guidance, DOJ explained that, along with its commitment to "protecting the American people from fraudulent practices in all industries, without exception," DOJ has ". . . no interest in pursuing or discouraging lawful conduct." DOJ further stated that: "[o]ur policy is not to prohibit or discourage financial institutions from providing payment processing services to customers operating in compliance with applicable federal and state law, and we are committed to tailoring our investigative efforts accordingly. Finally, we will continue to review our efforts to minimize any impact and collateral consequences on institutions we are not investigating." The DOJ letter has also failed to halt, or slow, the pace of bank discontinuance. In fact, it is continuing at breakneck speed.

Conclusion

Bank discontinuance of MSB accounts due to extra-legal regulatory pressure has reached epidemic proportions. Notwithstanding the FDIC and DOJ assertions that this activity is not ongoing, all indications are that it is, and an entire industry consisting of licensed businesses is being threatened with irreparable harm. The only way to halt the impending irreparable harm to our industry and to our customers is for the banking regulators to effect an immediate moratorium on bank discontinuance. During a moratorium, Congress can engage in considered oversight of recent regulatory efforts and their impact on licensed businesses, banks, and consumers. Furthermore, regulatory agencies should affirm for the Committee that no regulators have or are continuing to pressure banks to cease doing business with licensed and legally compliant businesses. Without a moratorium, MSBs will be forced out of business and the millions of Americans who rely on them for their financial services will be forced to untraceable or underground channels. There, consumers will be preyed upon by illegal, unscrupulous providers and long-established U.S. security objectives will be frustrated.

We appreciate the opportunity to submit this Statement with respect to this very important issue. We remain committed to continuing to work with the Committee and all interested parties in this regard.

EXHIBIT "A"

usbank. All of us serving you

September 18, 2013

Via UPS Return Receipt

Re: Accounts (the "Accounts")

Closure Effective: December 27, 2013

Dear

In accordance with your Deposit Account Terms and Conditions, please be advised that we have elected to close your Accounts with us.

The effective date of closure will not take place until the close of business approximately 90 (ninety) days from the date of this letter, on December 27, 2013. Accordingly, unless you choose to close the Accounts prior to that time, effective at the close of business on December 27, 2013, the Accounts will automatically close and be terminated. Once the Accounts are closed, you will no longer be able to conduct any banking business using the Accounts, including making deposits or initiating wire transfers. Any/all outstanding items presented against the Accounts will be returned as unpaid.

Effective immediately, any check, withdrawal, or other item presented for payment on the Accounts against insufficient collected or available funds will be returned. Therefore, deposits or transfers must be made prior to items being presented for payment. If deposit items consist of checks, please ensure that these deposits are made well in advance of any debit transaction to allow sufficient time for checks to be collected, per the assigned availability/float schedules related to the Accounts.

Unless the Company chooses to close the Accounts before the closure date, the Accounts will automatically close and be terminated on December 27, 2013. U.S. Bank will not extend this deadline. After the Accounts are closed, the Company will no longer be able to conduct banking business using the Accounts, including making deposits or initiating wire transfers. Any outstanding items, including checks, presented against the Accounts will be returned as unpaid.

The Company may close the Accounts before December 27, 2013. To do so, please call U.S. Bank Commercial Customer Service at 800-377-3053. The collected balance in the Accounts, after satisfying any outstanding service charges / costs or other outstanding obligations, if any, will be available as provided in your Deposit Accounts Agreement (the "DAA"). Alternatively, if we do not hear from you before December 27, 2013, U.S. Bank will automatically close the Accounts and mail any remaining balances to the Company in accordance with the DAA.

U.S. Bank reserves all rights and remedies available to it under the Deposit Account Terms, U.S. Bank Services Terms and Conditions or otherwise.

If you have any questions concerning this letter, please do not hesitate to contact me at 513-377-4472.

Sincerely,

Susan B Whitman

Susan B. Whitman
VP, Relationship Management
Commercial Banking Deposit & Payment Solutions

Bank of Hawaii

December 6, 2013

Re: Account Number(s) ending in

Dear Mr.

Bank of Hawaii has made a business decision to close your above-referenced business deposit accounts. The primary reason for this account closure is the Bank's increasing business expenses involved with servicing this type of account for a customer that operates as a money service business and/or payday lender. We apologize for any inconvenience this may cause you.

This letter will serve as notice of our intent to terminate the account(s) listed above (collectively, the "Checking Account") on March 6, 2014, pursuant to the Business Deposit Account Agreement governing the Account. We believe this will provide you with sufficient time to make other arrangements to meet your financial needs.

With respect to your Business CreditFlex Account No. (the "BCF Account"), please be advised that upon the termination of the Checking Account, payments due under your CreditLine under the BCF Account (the "CreditLine") and all fees and charges therefore will no longer be made by automatic deduction from the Checking Account. Instead, you will be receiving a monthly billing statement for your CreditLine, and you will be required to send in a monthly payment to Bank of Hawaii. You will continue to be able to borrow under the CreditLine by using Facility Checks, in accordance with the terms and conditions of the Business CreditFlex Agreement. Upon the termination of the Checking Account, you will no longer be able to borrow under the CreditLine by using Bankoh by Phone or e-Bankoh for Business.

As we previously discussed in September, the Bank is willing to discuss terming out a portion of the CreditLine under the BCF Account. A term sheet of proposed terms and conditions is enclosed, and we will be contacting you shortly about the term out.

If you have any questions, concerning this matter, please feel free to contact me at (808) 855-2743.

Sincerely,

Larry Dressler
Business Banking Officer

Bank of America
P.O. Box 32624
Charlotte, NC 28232-2624

Bank of America

Date
January 14, 2014

Customer service
1.800.626.2472

Account information
bankofamerica.com
/small business

Your Small Business account will be closed on March 14, 2014, and we want you to be able to plan ahead.

Account ending in:

We take a proactive approach to reviewing our customers' accounts. Most recently, we reviewed the nature of your business in light of current regulatory trends affecting your industry. After careful consideration we've decided to close your existing Small Business checking account listed to the right on March 14, 2014. We are giving you time to prepare. If you prefer, you can close your account prior to this date.

Your Deposit Agreement and disclosures, provided to you when your account was opened, state that the account may be closed by you or us at any time.

What you can expect

After your closing date of March 14, 2014, we'll mail you a cashier's check for the remaining balance in your account. The check will be mailed to the address we have on file within 5 business days of account closure.

What you need to know

Any checks you've written on your Small Business checking account that are presented for payment after the account is closed will be returned unpaid. In addition, your debit card will no longer access your account after it is closed.

If your account is or becomes overdrawn, you must deposit enough cash to bring the account to a zero balance

You'll want to make other payment arrangements to any merchants or service providers that you're currently paying electronically through an automated payment.

If you have a Small Business Credit Card, you will receive a separate notice regarding the status of that account.

Questions?

Please call us with any questions at **1.800.626.2472**, Monday through Friday from 8 a.m. to 8 p.m. Eastern and Saturday from 8 a.m. to 5 p.m. Eastern.

ARCVFTN4

Bank of America
Merrill Lynch

January 14, 2014

RE: Closure of your Bank of America Relationship

Pursuant to your recent conversation with your client manager, Bank of America (the "Bank") has determined that it wishes to close your relationship (accounts and services) in accordance with the deadlines outlined below.

Deposit accounts: When you opened your deposit accounts you signed a signature card and received a copy of the booklet which stated the terms and conditions under which your accounts with the Bank would operate. Both the signature card and the booklet provide that you or the Bank may close your accounts at any time, with or without notice.

I am writing to advise you that we are closing the following Bank of America accounts and terminating all treasury management services effective February 28, 2014.

xxxxxxxx
xxxxxxxx
xxxxxxxx
xxxxxxxx

On and after that date, we will not honor any withdrawals, funds transfers, checks or other transactions with respect to the accounts with the exception of any checks as to which we are a holder in due course and which have not been posted against your accounts prior to the closure date.

Please remember to contact any company that makes electronic debits or credits to your accounts to make other arrangements. In the meantime, we will pay checks and release funds against the accounts only upon our verification of sufficient collected and available funds in the accounts. Any checks or funds transfer requests that will result in a negative collected and available balance in the accounts will be returned.

Shortly after any account is closed, the Bank will send a check to the address of record for the remaining positive balance, unless you and the Bank agree on an alternative method of payment. Any checks or other funds transfer requests received after the closure date will be returned "Account Closed".

Your obligations under our account agreement, the Treasury Management Terms and Conditions, and any other agreements which arise prior to closure of the accounts will survive the closure.

January 14, 2014

RE: Closure of your Bank of America Relationship

Continued

We thank you for the opportunity to serve your business needs in the past and for your prompt attention in this matter.

Sincerely,

Account Closures Team
Special_Focus_Client_Closures@bankofamerica.com
980.388.1390

Peoples Credit Union

The Community Credit Union

LOCATIONS

PEMBROKE PINES
Corporate Headquarters
9560 Pines Blvd.
Pembroke Pines, FL 33024

BISCAYNE
11645 Biscayne Blvd.
Suite 101
North Miami, FL 33181

HIALEAH
8200 W. 33 Avenue
Bay 11
Hialeah, FL 33018

MIAMI
6301 Biscayne Blvd.
Miami, FL 33138

MIAMI BEACH
Mount Sinai Medical Center
4300 Alton Road
Miami Beach, FL 33140

NORTH MIAMI
680 N.E. 124th Street
North Miami, FL 33161

CALL CENTER
MIAMI-DADE
(305) 893-4880
BROWARD
(954) 704-4100

WEB SITE
www.pcufla.org

E-MAIL
contactus@peopcu.org

02/18/2014

Re: Account(s) closure

Dear

Please be informed that a business decision has been made to close your account with Peoples Credit Union. You have until April 18, 2014, to close the account. If it is not closed by that day, a check will be mailed to the address on file.

If you have any questions or concerns please feel free to contact the Credit Union at (954) 704-4100 or (305) 893-4880.

Peoples Credit Union Management

Hancock Bank. WHITNEY BANK

February 26, 2014

Subject: Notification of Account Closure(s) ending in:

Dear

We are unable to effectively manage your Account(s) on a level consistent with the heightened scrutiny required by our regulators for money service businesses due to the transactional characteristics of your business.

For this reason, please be advised that Hancock Bank|Whitney Bank is hereby exercising its contractual right, as set forth in the Terms and Conditions of the governing Deposit Agreement, to close the above referenced Account effective thirty (30) days from the date of this letter. Accordingly, we request that you accept this letter as official notification that Hancock Bank|Whitney Bank will no longer host the referenced Account(s). Please make the necessary arrangements to establish other banking relationships so the closing of this Account(s) will not unduly inconvenience you.

Any funds remaining in the Account(s) after the thirtieth day will be mailed to you at the address listed on the Account(s). Closing of the Account(s) does not release you from the payment of accrued fees or for other obligations incurred before closing (including obligations incurred in the process of closing out the Account(s), or for your liability on outstanding items.

We expect that this will provide you with sufficient time to move the Account(s) to another financial institution

Your cooperation in this matter is appreciated.

Respectfully,

Nycole Mckissack

Nycole Mckissack

Wells Fargo Bank, N.A.
EMCC-3.3.14
P.O. Box 5104
Sioux Falls, SD 57117-5104

March 03, 2014

Subject: Termination of Deposit Account(s) and Treasury Management Relationship

Last 4 digits of account(s):

Dear Customer,

Wells Fargo performs ongoing reviews of its account relationships in connection with the Bank's responsibilities to oversee its banking operations. After careful review, a business decision has been made to close your account(s) referenced above and terminate all related Treasury Management services (e.g. ACH origination services) associated with the above accounts.

We are writing today to let you know that the account(s) and related Treasury Management services and agreements will be terminated on **May 6, 2014**. We apologize for any inconvenience that this change may cause you. Please use this time period to make alternative banking arrangements with another financial institution.

As you make your alternative arrangements, please keep the following in mind:

- Following closure of the above mentioned account(s), a cashier's check for all remaining collected and available funds in the referenced account(s) will be mailed to the last address of record for your company within ten (10) business days of the date the account is closed. Uncollected funds, if any, will be forwarded after collection. Any related products or services associated with this account will also be closed.

- On the account closure date, monetary transactions on the account(s) will be blocked. This means:
  - Up until **May 6, 2014**, no checks or other orders of withdrawal presented for payment will be paid unless the account in question at the time of presentment contains sufficient collected and available funds to cover the checks or orders of withdrawal presented at the time. Checks drawn on your account which are present after **May 6, 2014** will be returned unpaid.
  - If any funds are directly deposited to this account, these deposits will no longer be accepted after the account is closed.
  - Any automatic payments from this account will be discontinued as of **May 6, 2014**.

If you have any questions, please contact your Business relationship manager.

Sincerely,

C. Alan Chudoba
Business Banking Group Risk Manager

FIFTH THIRD BANK

March 18, 2014

Dear

Fifth Third Bank recently performed an industry review to evaluate risk characteristics associated with typical customers as well as industry trends. Such a review can result in decisions to modify policies or controls, set concentration limits or exit an industry outside our risk tolerance.

During recent reviews of the payday lending industry, we have determined that the services provided by clients in this industry are outside of our risk tolerance. As such, we will no longer be able to provide financial services to businesses that operate in that industry. This decision impacts your business and will necessitate the closing of your accounts.

Next Steps
The complexity of closing your Fifth Third Bank accounts and transitioning services is unique to your situation, and Fifth Third Bank is committed to helping you through this transition. This work will need to begin immediately. Our intention is to exit the business relationships by June 30, 2014. We understand that in some cases, the complexity of services may require a longer exit timeline.

We will work with you to schedule a meeting in the coming days to formalize the transition plan.

Sincerely,

Robert Mangers
Vice President

Neil Mesch
Senior Vice President

FIFTH THIRD BANK

March 14, 2014

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We will work with you to schedule a meeting in the coming days to formalize the transition plan.

Sincerely,

Natan Milgrom
Natan.milgrom@53.com
216-274-5908

Bill Burke
Bill.Burke@53.com
216-274-5856

FIFTH THIRD BANK

March 6, 2014

Dear Mr.

Fifth Third Bank recently performed an industry review to evaluate risk characteristics associated with typical customers as well as industry trends. Such a review can result in decisions to modify policies or controls, set concentration limits or exit an industry outside our risk tolerance.

During recent reviews of the payday lending industry, we have determined that the services provided by clients in this industry are outside of our risk tolerance. As such, we will no longer be able to provide financial services to businesses that operate in that industry. This decision impacts your business and will necessitate the closing of your accounts.

Next Steps
The complexity of closing your Fifth Third Bank accounts and transitioning services is unique to your situation, and Fifth Third Bank is committed to helping you through this transition. This work will need to begin immediately. Our intention is to exit the business relationships by June 30, 2014. We understand that in some cases, the complexity of services may require a longer exit timeline.

We will work with you to schedule a meeting in the coming days to formalize the transition plan.

Sincerely,

Marti Lowe
Relationship Manager
Fifth Third Bank
2500 N. Dallas Pkwy, Ste 533
Plano, Texas 75093
972-543-1369
marti.lowe@53.com

Kurt Steves
Managing Director
Fifth Third Bank
2500 N. Dallas Pkwy, Ste 533
Plano, Texas 75093
972-535-0988
kurt.steves@53.com

EXHIBIT "B"

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Thursday, March 27, 2014 4:15 PM
To: D'Alessio, Edward P.
Subject: FW: bank discontinuence: here's my story

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Wednesday, March 26, 2014 7:21 PM
To: Ed D'Alessio
Subject: bank discontinuence: here's my story

Hello,

I operate 2 small payday loan stores in San Diego. I have been in the business for 15 years. We only do payday loans. I had accounts (checking and savings) with Chase for 12 years (average balances 50-80k) and 2 years ago I received a call from their regional person explaining to me they were closing all of my accounts.

When I asked why she said it was because of the business I am in and they did not want the audit risk. I could not believe it, as for 12 years, I never had even 1 returned check or any kind of overdraft.

All our processing is done electronically and these Chase accounts were just for deposits from our processor and for our customers to cash checks on our fully funded accounts. So I was just letting 80k sit in those account w/o any interest for all those years, being a good bank customer.....and they booted me out!

That's my story.

D'Alessio, Edward P.

From:	Ed D'Alessio [edalessio@fisca.org]
Sent:	Thursday, March 27, 2014 5:12 PM
To:	D'Alessio, Edward P.
Subject:	FW: MSB Bank issues - Five banks in six years.

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Wednesday, March 26, 2014 5:26 PM
To:
Subject: MSB Bank issues - Five banks in six years.

I operate in Traverse City, MI.

I opened the business in January 2008 and by then was already on my third bank, after two had dropped me, since then two more have dropped me. I have great credit, and no other issues. In each case I was told the issue was that I was an MSB.

Before opening I met with my banker at Chase Bank. I had a long term relationship with Chase. We were most of the way through this when my banker called with the news - Chase will not do business with an MSB, and if my other business' were associated with it they would also be dropped after doing business with that bank for over 40 years.

So I moved to Citizen's Bank - who stopped dealing with MSB before I even opened the store.

So I moved to the Bank of Northern Michigan, part of the Bank of Holland (Michigan) - they stopped doing business with MSB after about 7 months.

So I moved to National City (The ONLY bank I could find locally) and all was well until PNC purchased National City and PNC does not do business with MSB's.

So I found a bank out of the remote Upper Peninsula town of Manistique Michigan (2012 population 3047 persons. Seriously, look that up) that has a branch in Traverse City Michigan where I am located that does will work with me - so far...If I loose that bank I will have to go to a remote deposit bank with a $400/month fee structure and then have to try to figure out a way to find actual cash to load my store for operations.

So I have been with five banks and only open for six years.

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Thursday, March 27, 2014 5:44 PM
To: D'Alessio, Edward P.
Subject: FW: Bank Discontinuance for MSB's

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Thursday, March 27, 2014 4:17 PM
To: Ed D'Alessio
Subject: Bank Discontinuance for MSB's

Dear Mr. D'Alessio,

I am a owner in Tampa, Florida since 2006. This email is in response to. Since opening our MSB - three banks have canceled our accounts. In addition to the two most recent listed below - in 2007, Bay Cities Bank and in 2010 Wachovia (now Wells Fargo).

Most recently, we had three accounts with Bank of America. In a letter dated January 14, 2014 from Bank of America, we were notified that our small business (MSB) would be closed on March 14, 2014 giving us two months to obtain another MSB account with another bank. We immediately started visiting and calling every bank and credit union in the Tampa Bay area and we were turned down by every banking institution. We were able to obtain a bank in California (Merchants of CA), but because they are not local we are forced now to use their courier service which is very costly as we are not a high volume MSB.

On January 22, 2014, we opened a general business account with GTE Financial just to pay our utility bills, etc and obtain monetary change when needed. We were up front with the Manager when we requested the account and told him that we are an MSB and on March 21, 2014 we received a letter from GTE Financial closing our account effective March 31, 2014 - leaving us only 5 business days to obtain another account. They stated it was being closed due to the fact that we are an MSB. We called immediately asking why was the account opened then in the first place, as we were up front with them initially. Again, we called every bank and credit union in the Tampa Bay area and all turned us down for just a small business account.

We hope that you can help MSB's with this dire and ridiculous situation. We plan to contact the State of Florida Banking Commission, our State Representatives and Congressman, etc. as well.

Sincerely,Owner

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Thursday, March 27, 2014 5:43 PM
To: D'Alessio, Edward P.
Subject: FW: From Calvin (Cash Plus#231) Dover DE

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Thursday, March 27, 2014 4:12 PM
To: Ed D'Alessio
Cc:
Subject: From

3/27/2014
Mr. Alessio,
My name is , based in Dover, DE. I have recent bought in

My business is also located in Dover De, the construction is all completed and almost ready for business but the only thing that's stopping me to do so is opening a MSB business account at the bank. My partner and I currently own and operate various businesses such as restaurant, liquor store, multiple franchises such as papa johns and Verizon wireless in different states (DE, MD, PA, AL) never had any issues to open up business accounts. Then we had an idea of getting into Money Servicing Business, since I had worked in corporate bank for more than eight years. I might say that I might have a better knowledge of the (rules, regulation, compliance related issues and more) than some. Well to make long story short.
We decided to get into this business not as a mom and pop shop doing check cashing in any of our stores but get involved with , since they have been in business for more than 29 years and running, with a great knowledge and experience the company has to provide, most importantly they have a great BSA/AML procedures and policies that we follow. So that been said Late last year the project began, the first thing we did was contact our PNC Bank that we currently have business relationship for many years. Told them we need to open up a new business account for the new venture, they were more than glad but when we said it need to be set as a MSB account the atmosphere changed. Saying we don't open any MSB accounts and also said that, the once we have are also slowing closing down. I asked WHY? They say it's too risky, I requested to please explain, and then they said well a lot of this check cashiers (Gas Station, convenient store etc.) are not licensed or registered as a MSB on Fincin. Then my question was what about the once that are registered? And all they said is but we also don't have the manpower for the compliance department to handle this type of business and then all I felt like I was just talking to a wall because they dint want to hear any other word about MSB. Well this was just PNC Bank part.
Then I went to Wells Fargo Bank they said "yes" we do service MSB account, but our slots for the last quarter is completed but come 1st quarter of this year a new slot will open, so they told me lets open a general business account with my corporate name and EIN number, so come 1st quarter we shall either convert this account or

just set a new account. I said fine and got things started, and then I got busy with my store construction and other thing. Now came the 1st quarter, so later part of February, I called Wells Fargo since no one called me, the same person I spoke to last year now says well Wells Fargo has decided not to open up new MSB account period……. And says almost the same things that PNC Bank told me before, Well since then I have been calling and talking face to face with multiple bank from(East to West) and (North to South) everyone says "no" with a little twist in the story. Some say you have to be in the MSB business for at least 3 years to open a new account and the once that they already have has been grand fathered in.
I could list all the name of the bank and numbers and also the people's names that I spoke to in those banks, but that will take good 2 or 3 additional pages, if they is any information you would like to get from me, just send any email or call at . Last thing I need to point out is that due to this big issue regarding, not being able to open a MSB account, I have already invested more than $100,000.00 in the project which is standing still and also the potential employees are still without a job. On a personal note we are trying to grow the business and also provide jobs locally and most of all help our potential customers with the financial needs. I hope this matter is seriously taken, since this is for sure hurting small business group like us.

Thank you.

Sir,
My name is and I am a . I opened my check cashing business in May of 2013 after working very closely with my local Bank of America representative. We had many conversations where I explained how important having an MSB account was. He worked with me over several months and I believe he was as excited as I was when he informed me I had been approved for an MSB account. I had told him that I had invested most of my personal retirement funds into this business. Once we opened for business, the Bank of America compliance dept. requested information frequently, and I submitted each and every document, procedure or manual in a timely manner. We received notice in August of 2013, barely 90 days after opening our account and our business, that we had 90 days to find another financial institution because our account was being closed. Bank of America had to know how difficult that would be, it took them over 5 months for them to grant me an account. I had invested over $300,000.00 of my retirement savings into this business and faced losing it all if I couldn't establish an MSB account in under 90 days. Not only that, Bank of America had required a security instrument in the form of a CD in the amount of $32,000.00, which they refuse to release for one year. This has created a hardship on my business as that is working capital that I am unable to use. Fortunately I was able to find another bank, Merchants Bank of California. They also required a security instrument tying up even more capital. One of the reasons I sought a Bank of America account is that they have branches in my city, my new bank is located completely across the country. This creates a logistical nightmare, and significantly higher costs of doing business. When I was notified that Bank of America was terminating my account I inquired at both the local and corporate level as to why. I stressed that if there was a compliance issue or deficiency I needed to know so that it could be corrected. At each level they refused to give a reason as to why the account was being closed. I feel if a bank wishes to terminate a clients account it should be mandatory that they at least inform the account holder why, and give a reasonable amount of time (equal to the average amount of time it takes **them** to approve new MSB customers).

Sincerely,

[redacted]

:rom: [redacted]
;ent: Monday, February 03, 2014 8:16 AM
'o: [redacted]
;ubject: Thank You

;entlemen, thank you for taking the time to update us on Friday.

n spite of the strange market and excessive scrutiny, you have done very well.
:ongratulations.

wanted to thank you for your loyalty.
know you had options other than [redacted]
hanks for staying with us.

ased on your performance, there's NO WAY we SHOULDN'T be a credit provider.
ur only issue is, and it has always been, the space in which you operate.
has never been the service that you've provided or the way you operate.
ou've obviously done a brilliant job.
is the scrutiny that you, AND NOW THAT WE, are under.

/e'd like to stay in touch.
promise we will keep an open mind.
hanks again.

[redacted]
:ecutive Vice President and Manager

[redacted]

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Wednesday, March 26, 2014 5:34 PM
To: D'Alessio. Edward P.
Subject: FW:

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Tuesday, March 11, 2014 4:57 PM
To: Ed D'Alessio
Subject: FW: Bank Discontinuance

From:
Sent:
To:
Subject:

FYI

I had a small check cashing business with 2 locations in CT for the last 2 years. I say had because I have recently turned in my licenses to the state and have closed the company. Our accounts were terminated by 2 different banks while we were open. Their explanation was simply we are no longer dealing with MSB's.

I had tried to locate another bank for our MSB account for 6 months and simply could not find one with reasonable fees that would open an account for a MSB.

Regards

-----Original Message-----

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Thursday, March 27, 2014 4:00 PM
To: D'Alessio, Edward P.
Subject: FW: bank closure

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Thursday, March 27, 2014 11:17 AM
To: Ed D'Alessio
Subject: bank closure

Good Morning
I am writing this to tell you of 2 different bank closures that I have experienced. I own . store in Toledo OH and approx 18 months ago I set up a checking account with Bank of America. After going through several hours of paperwork and required forms they informed that I was approved for a new checking account. When I went into BOA to sign the paperwork they told me that sometimes they require a reserve to maintain the account and told me that this amount would be approx $1000-$3000. I was ok with that and proceeded to order my checks etc. After approx 30 days I got a certified letter from BOA stating that I would have to pay them $30000 to keep the account open or it would be closed immediately. I called their MSB department and the told me that after the account is open it is reviewed and then determined what the reserve would be. After I told her that I was told the reserve would be $1k-3K and this amount would put me out of business, her response was she shouldn't of told you that. Also she informed me that the $30,000 would be held indefinitely or 1 year after I closed the account. Fortunately I was also in the process of opening another account before I went to BOA and was able to get the account opened pretty quickly and not have the account closed. The reason that I was looking to open a new checking account with Bank of America was because I had received a letter from Huntington Bank the summer of 2012. I was dealing with HNB for over 3 years with no problems. I complied with all information they had requested during that period and maintained a substantial amount of money in that checking account. Then in early summer of 2012 I received a certified letter from Huntington Bank claiming they were no longer going to service MSBs and that I had 30 days to close the account. My store has been open for over 6 years and have never bounced a check or not complied with anything that any bank has requested and in my opinion we are being treated unfairly on this issue. Last year I had an MSB audit with the IRS and asked the agent about this and he claims that he did not know or understand why the banks were closing MSB checking accounts but that the IRS didn't have anything to do with it. As far as I can tell there isn't a local bank in Northwest Ohio that will do business with an MSB.

To Whom It May Concern **March 30, 2014**

Re: Bank Discontinuance

When my wife and I first moved to Jacksonville, Florida, we were very excited about opening our first business. After a lengthy search in 2005, we decided on a Franchise called . a Money Service Business, providing Check Cashing, Payday advance, Western Union and similar services from a retail service center. We liked the customer service and marketing aspects, and felt that we'd enjoy helping folks who need help, while the Franchise would help provide direction with compliance and operations.

Since then, we've worked hard within our community, contributing through volunteer work and donations while having a mutually respectful relationship with our customers and employees. Of course, it's been difficult in many ways, but I can't imagine any business, especially starting from no customer base, is easy. We quickly found out that, in the MSB industry, even if you have a credit rating within the top 99.9% of the country, it's nearly impossible to get a loan, or credit card, connected to the business.

A larger issue that stands out, above and beyond the typical every day challenges that we've faced, has been keeping a bank account open, which is essential to service our customers. Even though all of our activity is compliant with the banks policies, Federal, State and local regulations, we have had at least 6 different banks close our business account over the years. When I begged for a reason on why this happened, I've been told our business is too risky, too costly, or they are simply 'getting out of the MSB' market. I can understand that there are some bad apples out there, that have not followed the Patriot ACT, FiSCA guidelines, or other Money Service Business regulations, but I myself have kept my business fully compliant and have worked very hard to stay in great standing, and have received excellent reviews and audits from both Federal and State level regulators, our Franchisor, and every bank and vendor we've worked with over the years (backup documentation included).

The most recent experience has been with the closing of all four of our MSB Bank of America (BOA) accounts, which we had used for over 5 years. We have a great relationship with BOA's Assistant Vice President of Small Business Banking and Client Development Group and our Client Manager, John E. Winiewicz, along with a great rapport with the Vice President at the Regency Square BOA branch and several levels of management and employees at some local branches here in Jacksonville, Florida.

We have several letters from BOA's compliance department, which are sent out every year when they complete their annual reviews of their MSB's, indicating that they were always satisfied, or overly-satisfied, with the MSB documentation we provided.

On January 14, 2014, I received an email from John Winiewicz indicating that I would get a letter from BOA and that they are closing all four of our MSB accounts by the end of February. I received that letter shortly after. I asked John if I can get some more time, than only 1.5 months, since finding a bank account which can service our needs in Jacksonville is a difficult and timely task, especially in the middle of Tax Season, but he said no. BOA had also closed my BOA credit card account years ago because I was related to an MSB, which also had always been in great standing, and always paid.

BOA had no problem keeping my personal accounts and my software business accounts open, since they were not related to the MSB industry.

Further, John indicated to me that the MSB accounts were being closed because it was too costly to oversee the account and reporting necessary, however, if you read the attached emails from August 2013, just prior to the closing of my accounts, John told me that BOA was doing a survey and asked some questions regarding payday lending percentages and payback habits, so it's difficult to determine what the real reasons are.

By writing this letter and providing detailed backup documentation, I'm hoping to provide some more visibility to the issue, so we can take a close look at why banks are really discontinuing accounts for MSB's, who are fully transparent and compliant, and keep their bank accounts in very good standing.

We provide our customers a valuable and honest service. They like us, and tell us that all the time. Our services are convenient, and there is a value that we can provide above and beyond any other industry, as indicated by our industries high customer satisfaction scores across the country.

Again, I understand that there may be some others out there that have not properly run their MSB's and this can reflect badly on the banks and our industry, but this seems to be no different than other types of bank accounts, which certainly have the same challenges of managing the accounts based on that customers individual account performance, and not the industry they are in.

I've included contact names and backup documentation for your review. Please do not hesitate to contact me for further information.

Sincerely,

D'Alessio, Edward P.

From: Ed D'Alessio [edalessio@fisca.org]
Sent: Tuesday, April 01, 2014 10:11 AM
To: D'Alessio, Edward P.
Subject: FW: RE: RE:

Edward P. D'Alessio
Executive Director
Financial Service Centers of America
1730 M Street, NW
Suite 200
Washington, DC 20036
201-562-1022 (d)
202-719-2388 (o)
201-446-3226 (m)

From:
Sent: Tuesday, April 01, 2014 10:01 AM
To: Ed D'Alessio
Subject: Re: RE:

Ed,

I want to share a situation that sums up the horrendous banking relationships with our industry. I am selling a store in Dover, The buyer already has had one license for 15 years with Fulton Bank. I might not be able to sell the store for the Bank will not open up a new account. Then I suggested he buy my store as a branch office and use his existing account. They won't let him do that either!

ICBA
INDEPENDENT COMMUNITY BANKERS of AMERICA®

April 8, 2014

Community Bank Regulatory Relief Will Grow Economy and Create Jobs

On behalf of the nearly 7,000 community banks represented by ICBA, thank you for convening today's hearing on "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom." Community banks nationwide have identified regulatory burden as a top concern and impediment to their viability and ability to provide credit in their communities. We welcome this opportunity to submit ICBA's statement for the record.

America's nearly 7,000 community banks are critical to the prosperity of the U.S. economy, particularly in suburban and rural communities. Providing 60 percent of all small business loans under $1 million, as well as customized mortgage and consumer loans suited to the unique characteristics of their local communities, community banks are playing a vital role in ensuring the economic recovery is robust and broad based, reaching communities of all sizes and in every region of the country.

ICBA "Plan for Prosperity" Outlines Regulatory Relief Recommendations

In order to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, community banks must have regulation that is calibrated to their size, lower-risk profile, and traditional business model. A one-size-fits-all regulatory system for the banking sector is tremendously detrimental to community banks and the local economies they serve and support. Working with community bankers from across the nation, ICBA has developed its Plan for Prosperity, a platform of legislative recommendations that will provide reasonable and meaningful relief for community banks and allow them to thrive by doing what they do best – serving and growing their communities. By rebalancing unsustainable regulatory burden, the Plan will ensure that scarce capital and labor resources are used productively, and not sunk into unnecessary compliance costs, thus allowing community banks to better focus on lending and investing that will directly improve the quality of life in our communities. Each provision of the Plan was crafted to preserve and strengthen consumer protections and safety and soundness. The Plan for Prosperity is attached to this testimony.

ICBA is grateful to this committee for advancing many key provisions of the PFP. To date this committee has passed seven bills that contain PFP provisions, be they single provision bills or multiple provision bills. Four of those bills have gone on to pass the full House. We encourage this committee to continue its consideration of community bank regulatory relief legislation, in particular the CLEAR Relief Act (H.R. 1750), introduced by Rep. Blaine Luetkemeyer, himself a former community banker, which contains many of the provisions discussed in this statement.

1615 L Street NW, Suite 900, Washington, DC 20036 ▪ 202-659-8111 ▪ Fax 202-659-9216 ▪ www.icba.org

New Empirical Study Illustrates Regulatory Impact

While we have recommended specific regulatory relief measures in our Plan for Prosperity, the problem is a cumulative one. As regulations have accreted steadily over the past few decades, they are rarely removed or modernized, resulting in a redundant and sometimes conflicting burden.

ICBA is grateful to the Mercatus Center for producing a high quality empirical study on the impact of recent regulations on community banks.[1] The study, which is based on a survey of survey of approximately 200 community banks in 41 states with less than $10 billion in assets, is largely consistent with what we've heard firsthand from community bankers across the country. Broad findings from the study include:

- **Additional costs.** Approximately 90% of respondents reported that compliance costs have increased since Dodd-Frank. 83% reported that they had increased by more than 5%. (Because the survey question does not capture cost changes of magnitude greater than 5%, costs could have increased by a much higher percentage, as anecdotal accounts suggest.)
- **Outside consultants.** More than half of surveyed community banks (51%) anticipate engaging with outside consultants in connection with Dodd-Frank, and an additional 21% are unsure.
- **Additional compliance personnel.** Dodd-Frank has caused respondent banks to hire additional compliance/legal personnel. 27% of respondents plan to hire additional compliance/legal personnel in the next 12 months, and an additional 28% are unsure. The survey also finds that employees not exclusively dedicated to compliance, including CEOs and senior managers, are forced to spend more time on compliance issues.
- **Dodd-Frank is driving consolidation.** 26% of respondents anticipate that their bank will engage in merger activity in the next five years, and another 27% are unsure. 94% of banks anticipate further industry consolidation.

Overall, new rules comprise a significant new burden for community banks and will negatively impact their customers. In addition to providing empirical analysis, the study reports narrative comments provided by survey respondents at their discretion. Here are a few examples:

- "This piece of regulation is written so unclearly with so many trip wires that serve no benefit to customers that we anticipate not offering a mortgage product."
- "We don't have the number of employees or the financial resources to keep up with Dodd-Frank and [its] rules ... Why make it harder for community banks to do business and survive? We fill a niche that larger banks can't and won't."

[1] "How are Small Banks Faring Under Dodd-Frank?" Hester Peirce, Ian Robinson, and Thomas Stratmann. Mercatus Center Working Paper. February 2014.

- "Community banks that know their customers will struggle to be able to continue to lend to good, long-term customers."
- "Many concerned, conscientious community bankers are selling out or just retiring due to the maddening pace of illogical & unnecessary regulation. Not one of the regulations we've seen would have done anything to prevent the 2008 collapse."

These comments, offered anonymously by bankers charged with real world implementation of the new rules, illustrate how increasing regulatory burden is fundamentally changing the nature of the business of community banking.

This statement will include more empirical findings from the Mercatus Center study in the context of specific regulations discussed below, beginning with our recommendations to preserve community bank mortgage lending.

Plan for Prosperity Mortgage Reform for Community Banks

Every aspect of mortgage lending is subject to new, complex, and expensive regulations that will upend the economics of this line of business. These regulations have been enacted in response to the worst abuses of the pre-crisis mortgage market – abuses in which community banks did not engage.
Key provisions of the Plan for Prosperity are designed to keep community banks in the business of mortgage lending. The Plan for Prosperity focuses on those reforms that will have the greatest impact and are ripe for enactment, including:

- "Qualified mortgage" safe harbor status for loans originated and held in portfolio for the life of the loan by banks with less than $10 billion in assets, including balloon mortgages;
- Exempting banks with assets below $10 billion from escrow requirements for loans held in portfolio;
- Increasing the "small servicer" exemption threshold to 20,000 loans (up from 5,000); and
- Reinstating the FIRREA exemption for independent appraisals for portfolio loans of $250,000 or less made by banks with assets below $10 billion.

ICBA appreciates the CFPB's efforts to accommodate community banks in their recent rulemakings. However, we believe that it did not go nearly far enough in providing for needed tiered regulation, as does the Plan for Prosperity, that will preserve the role of community banks in the mortgage marketplace.

Community banks represent approximately 20 percent of the mortgage market, but more importantly, much of this mortgage lending is concentrated in the small towns and rural areas of

our country, which are not effectively served by megabanks. As the FDIC Community Banking Study showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.[2]

Community banks have a starkly different business model than that of larger mortgage lenders, which are driven by volume and margins. Community banks, by contrast, are relationship lenders with deep roots in their communities. Their mortgages are well underwritten because they know their customers, their businesses or employers, and the local economic conditions. The strength of their underwriting is confirmed by Federal Reserve data. In recent years, the delinquency rate of mortgages held by community banks never exceeded 4 percent, compared to 22 percent for fixed rate subprime mortgages and 46 percent for subprime variable rate mortgages. In fact, community bank mortgages have outperformed fixed rate prime loans, thought to be the best performing category of all loans.[3] New mortgage rules for community banks are unwarranted. A host of new, expensive, complex, and unworkable mortgage rules will only drive further industry consolidation until we are left with only a handful of mega-mortgage lenders. That outcome would only decrease competition and increase systemic risk in the mortgage and housing markets.

A chief characteristic of community bank mortgages in small and rural communities is that they are often collateralized by unique properties without adequate comparable sales and don't fit the inflexible requirements of the secondary market. In addition, the borrowers may be farmers or small business owners whose debt-to-income ratios fall outside of secondary market parameters, despite their personal net worth and means to repay the loan. Large lenders shun such loans because they don't fit their automated underwriting models and require first-hand assessment of the property and the borrower. Only community banks are willing to extend credit to such borrowers, often through the use of balloon loans held in portfolio. Because holding a fixed rate 15 year or 30 year mortgage on the books would expose a community bank to unmanageable interest rate risk, these loans are made typically for 3 or 5 years, and repriced and renewed when they come due. Community banks have safely made balloon mortgages for many decades.

In a recent survey of community banks, 50 percent of respondents indicated they hold all of their mortgage loans in portfolio, and 72 percent of respondents hold at least half of their mortgage loans in portfolio.[4] While secondary market sales are a significant line of business for an important segment of the community banking industry, ICBA estimates that community banks under $10 billion in assets may hold as much as $412 billion in balloon payment mortgages for

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[2] FDIC Community Banking Study. December 2012.
[3] "Community Banks and Mortgage Lending," Remarks by Federal Reserve Governor Elizabeth Duke. November 9, 2012.
[4] ICBA Mortgage Lending Survey, September 2012.

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as many as 5.5 million borrowers.[5] For many community banks, portfolio lending is a function of the types of mortgages they underwrite – mortgages that cannot be securitized.

Another function of community bank customized underwriting is that the loans often meet the regulatory definition of "higher priced mortgage loans" (HPML). Because these loans cannot be securitized they must be funded through retail deposits which include higher cost certificates of deposits, and this results in a higher interest rate. The regulatory definition of HPML is heavily weighted toward the pricing that Fannie Mae and Freddie Mac set based on their ability to access capital and funding markets that are not available to community banks. In addition, in today's historically-low interest rate environment, it is more likely that a reasonably-priced loan will meet the Federal Reserve's definition of "higher priced." Almost half of survey respondents (44 percent) said that more than 70 percent of their loans fell within this definition of "higher priced."

This lending model – customized balloon loans held in portfolio and, due to a higher cost of funds, priced higher than securitized loans – has worked well for decades and is a proven private market solution that serves certain borrowers and communities that cannot access the secondary market. If this lending model is made infeasible by new regulation, rural borrowers will have no place to turn and will be deprived of credit. The communities they live in will stagnate.

This community bank model of providing mortgages and making home ownership possible to those who, in many cases, would have no other option is under direct threat because the loans share superficial characteristics with subprime loans such as balloon terms and relatively high rates – loan terms that have been targeted by new mortgage regulation. The new ability-to-repay regulations will expose lenders to litigation risk unless their loans meet the definition of "qualified mortgage."

Similarly, "higher priced" loans – even when that pricing is aligned with the lender's cost of funds, risk, and other factors – are excluded from the conclusive presumption of compliance (or "safe harbor") protections under "qualified mortgage" and instead carry only a "rebuttable presumption of compliance," a much weaker protection which exposes the lender to unacceptable litigation risk for the life of the loan. HPMLs are also subject to escrow requirements, which many community banks cannot comply with. We appreciate that the CFPB adopted a higher price trigger for the safe harbor for community bank loans – 3.5 percent above average prime rate offer (APOR) – though we remain concerned that even this higher trigger does not fully capture a community bank's cost of funds.

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[5] This estimate is based on recent call report data which shows that community banks under $10 billion in assets hold a total of $550 billion in residential 1-4 family mortgages. Assuming that balloon payment mortgages account for 75% of community bank mortgages assets, which is consistent with survey results, the result is $412 billion in balloon payment mortgages. Assuming an average loan balance of $75,000, the result is 5.5 million borrowers.

The QM rule poses a daunting challenge, is changing the way that community banks lend, and reducing access to credit in our communities. According to the Mercatus Center study, 56% of respondents reported that the QM rule will have a significant negative impact on mortgage lending. An additional 29% report that these factors will have a slight negative impact.

CFPB "small creditor" accommodations do not go far enough

The final QM rule makes accommodations for "small creditors," defined as banks that originate fewer than 500 mortgage loans annually and have less than $2 billion in assets. Loans originated and held in portfolio by small creditors receive QM status -- provided they meet a number of limiting conditions and subject to a prescriptive compliance analysis. However, the small creditor accommodations do not go far enough. For example, for a balloon loan to qualify for a small creditor QM, the bank must have made at least 50 percent of its first lien mortgages in rural or underserved counties under unreasonably narrow definitions of "rural" and "underserved." According to an anonymous community banker quoted in the Mercatus Center study: "I am located in a county listed as an MSA, and while I watch a corn field and grain bins from my window, I can't be considered a rural bank. It makes no sense." Though the CFPB has suspended application of the rural definition for small creditors until 2016, this deferral does not provide community bankers with the certainty required for long-term business planning. In addition to balloon loans, small dollar loans, which are common in many parts of the country for purchase or refinance, face an unreasonably low ceiling on closing fees in order to qualify under the current QM rule.[6]

Finally, the QM rule requires a very prescriptive and fully documented analysis of the borrower's income and debt, which is particularly difficult for first time homebuyers. All of the above hurdles apply even under the broader terms available to "small creditors." Community banks need a solution that will provide for more clarity and simplicity in QM designations without tortuous analysis.

In addition, many banks that fail either the loan volume or the asset test or both of the small creditor definition are in fact community banks with all the characteristic features including local deposit funding, narrow footprint, personalized service, and specialization in traditional products and services. What's more, the loan volume test is not consistent with the asset test. A $400 million ICBA member bank, well below the "small creditor" threshold, has an annual loan volume which, while variable from year to year depending on demand, is uncomfortably close to the 500 loan threshold. Under the current rule, this community bank has no incentive to increase its loan volume and thereby lose its small

[6] The fee cap is applied on a sliding scale. A loan between $60,000 and $100,000, for example, would face a $3,000 cap, which is not feasible for a community bank.

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creditor status. While we don't have data comparing loan volume to asset size, we do not believe this bank is atypical.

Plan for Prosperity Solution: "Qualified Mortgage" Status for Community Bank Portfolio Loans

The Plan for Prosperity solution to this new regulatory threat is reasonable, simple, straightforward and will preserve the community bank lending model described above – safe harbor "qualified mortgage" status for community bank loans held in portfolio, including balloon loans in rural and non-rural areas and without regard to their pricing. When a community bank holds a loan in portfolio it holds 100 percent of the credit risk and has every incentive to ensure it understands the borrower's financial condition and to work with the borrower to structure the loan properly and make sure it is affordable. Withholding safe harbor status for loans held in portfolio, and exposing the lender to litigation risk, will not make the loans safer, nor will it make underwriting more conservative, it will merely deter community banks from making such loans in the many counties that do not meet the definition of rural and where a bank's cost of funds results in "higher priced mortgages." Many community banks will be forced to make a risk-reward calculation to determine whether they will continue providing mortgage financing in their communities.

Plan for Prosperity Solution: Escrow Requirement Exemption for Community Bank Portfolio Loans

Escrow requirements for property taxes and insurance are an additional deterrent to community bank mortgage lending. Loans held in portfolio by community banks should be exempt from such requirements. When loans are held in portfolio, lenders have every incentive to protect their collateral by ensuring that tax and insurance payments are current. The escrow requirement for higher priced loans is unnecessary, impractical, and a significant expense for a community bank. A large majority of community banks do not currently escrow because of the cost and requiring them to do so will only deter them from making higher cost loans. In a September 2012 ICBA survey of more than 430 community banks, 55 percent of the bankers stated they decreased their mortgage business or completely stopped providing higher-priced mortgage loans due to the expense of complying with escrow requirements for higher priced mortgages that took effect in 2010. Many community banks do not have the resources to do it in house. Outsourcing escrow services may not be an affordable option either. For third party servicers it is simply not economical to offer escrow-only services, not packaged with other services, to low volume lenders. The Plan for Prosperity calls for an exemption from escrow requirements for community bank loans held in portfolio.

Introduced Legislation

ICBA is very pleased that portfolio loan relief has been included in four bills introduced in the House.

- The Protecting American Taxpayers and Homeowners Act (H.R. 2767), introduced by Chairman Jeb Hensarling and Representative Scott Garrett, would provide QM status to any mortgage originated and held in portfolio; among other mortgage reform provisions.
- The CLEAR Relief Act (H.R. 1750), noted above, would grant QM status to mortgages originated and held in portfolio for at least three years by a lender with less than $10 billion in assets; among other mortgage reform provisions.
- The JOBS Act (H.R. 4304), introduced by Rep. Steve Scalise (R-LA), incorporates the CLEAR Relief Act in full; among other provisions.
- The Portfolio Lending and Mortgage Access Act of 2013 (H.R. 2673), sponsored by Rep. Andy Barr (R-KY), would grant QM status to any residential mortgage loan held in the originator's portfolio.

Plan for Prosperity Solution: Small Servicer Exemption

The relationship lending model, so important to community banks, extends beyond underwriting to servicing. Community banks frequently service the loans they originate, whether they are held in portfolio or sold into the secondary market. For community banks that sell their loans, retention of servicing is important to maintaining long-term relationships with customers and the opportunity to meet their future banking needs.

The community bank practices that strengthen underwriting and result in better loan performance also produce stronger servicing. Bankers that know their customers and the economic trends in their communities can better anticipate borrowers' potential difficulties and intervene early and effectively. As is true with underwriting, the data clearly show that community bank serviced mortgages perform better. Public policy should keep community banks in the business of servicing mortgages and deter further consolidation among servicers.

In this regard, community banks are deeply concerned about the impact of servicing standards that are overly prescriptive with regard to the method and frequency of delinquent borrower contacts, reducing community banks' flexibility to use methods that have proved successful in holding down delinquency rates. Examples of difficult and unnecessary requirements include new monthly statements; additional notices regarding interest rate adjustments on ARM loans; rigid timelines for making contacts that leave no discretion to the servicer; and restrictions on

forced placed insurance. Community banks' small size and local presence in the communities they serve make many of these requirements unnecessary.

The CFPB's recent servicing rule provides a small servicer exemption for banks that service fewer than 5,000 loans. We appreciate recognition that the rule is not appropriate for smaller servicers but believe that the CFPB set the threshold too low. Many community banks service larger portfolios that should qualify for an exemption because they use the community bank servicing practices and obtain the strong performance results. For example, a West Virginia community banker is not exempt because he services 6600 accounts, yet has a very low delinquency rate, less than 4 percent. This banker estimates the monthly statement requirement alone will cost him about $181,500 annually. He will also have to hire an additional collector, even with his low delinquency rate, to comply with the new early intervention requirements. ICBA's Plan for Prosperity calls for raising the small servicer exemption threshold to 20,000 loans. To put this proposed threshold in perspective, the average number of loans serviced by the five largest servicers subject to the national mortgage settlement is 6.8 million.[7] An exemption threshold of 20,000 would more clearly demarcate small servicers from both large and mid-sized servicers. It would help preserve the important role of community banks in servicing mortgages and deter further industry consolidation which is harmful to borrowers.

Introduced Legislation

ICBA is very pleased that the CLEAR Relief Act (H.R. 1750), which is noted above, as well as the JOBS Act (H.R. 4304), raise the small servicer threshold to 20,000 loans. The CFPB has authority to raise this threshold without legislation and should do so.

Plan for Prosperity Solution: Appraisal Exemption for Community Bank Portfolio Mortgages

Appraisal standards have changed significantly over the past few years. First as a result of the Home Valuation Code of Conduct from Fannie Mae and Freddie Mac, and more recently as a result of the Dodd-Frank Act. These standards are well intentioned, having been designed to prevent abuses by unregulated mortgage brokers that contributed to the collapse of the housing market. However, they have made it nearly impossible for many banks to use local appraisers. The only practical option for a community bank mortgage lender is to use an appraisal management company, which significantly increases appraisal costs for borrowers. ICBA's Plan for Prosperity calls for reinstating the FIRREA exemption for independent appraisals for portfolio loans of $250,000 or less made by banks with assets below $10 billion.

[7] Source: Office of Mortgage Settlement Oversight (www.mortgageoversight.com).

Introduced Legislation

The CLEAR Relief Act (H.R. 1750), which is noted above, as well as the JOBS Act (H.R. 4304), provide an exemption from the independent appraisal requirement for mortgages of less than $250,000.

Plan for Prosperity Solution: Relief from Accounting and Auditing Expenses for Publicly Traded Community Banks and Thrifts

Another provision of the Plan for Prosperity would increase the current exemption from the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. Because community bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded community banks without creating more risk for investors.
Separately, due to an inadvertent oversight in the recently-passed JOBS Act, thrift holding companies cannot take advantage of the increased shareholder threshold by which a bank or bank holding company may deregister as an SEC reporting company under Section 12 of the Securities Exchange Act of 1934.

Introduced Legislation

The CLEAR Relief Act (H.R. 1750) and the JOBS Act (H.R. 4304) exempt community banks with assets of less than $10 billion from the Sarbanes-Oxley 404(b) internal-controls assessment mandates. The exemption threshold would be adjusted annually to account for any growth in banking assets.

The Holding Company Registration Threshold Equalization Act (H.R. 801), introduced by Reps. Steve Womack and Jim Himes, which will correct the oversight in the JOBS Act and allow thrift holding companies to use the new 1200 shareholder deregistration threshold. ICBA is grateful to this committee and the House for passing H.R. 801.

Plan for Prosperity Solution: New Charter Option for Mutual Banks

Mutual community banks are among the safest and soundest financial institutions. They remained strong during the financial crisis and continued to provide financial services to their customers. The Plan for Prosperity calls for the creation of a new OCC charter for mutual national banks. This option would provide flexibility for institutions to choose the charter that best suits their needs and the communities they serve.

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Introduced Legislation

The Mutual Community Bank Competitive Equality Act (H.R. 1603), introduced by Reps. Michael Grimm (R-NY), Gregory Meeks (D-NY), and Peter King (R-NY), allows the OCC to charter mutual national banks. The Mutual Bank Choice and Continuity Act (H.R. 4252), introduced by Rep. Keith Rothfus (R-PA), also provides a national charter option.

Plan for Prosperity Solution: Cost-Benefit Analysis for New Rules

The Plan for Prosperity calls for legislation to prevent the financial regulatory agencies from issuing notices of proposed rulemaking unless they first determine that quantified costs are less than quantified benefits. The analysis must take into account the impact on the smallest banks which are disproportionately burdened by regulation because they lack the scale and the resources to absorb the associated compliance costs. In addition, the agencies would be required to identify and assess available alternatives including modifications to existing regulations. They would also be required to ensure that proposed regulations are consistent with existing regulations, written in plain English, and easy to interpret.

Introduced Legislation

The SEC Regulatory Accountability Act (H.R. 1062), introduced by Rep. Scott Garrett (R-NJ), which would require the Chief Economist of the SEC to determine that the benefits of any proposed regulation justify the costs before adopting such regulation. ICBA thanks this committee and the House for passing H.R. 1062.

The CLEAR Relief Act (H.R. 1750) and the JOBS Act (H.R. 4304) would require the SEC to conduct a cost-benefit analysis of new or amended accounting principles.

Plan for Prosperity Solution: Consumer Financial Protection Bureau Reform

The CFPB is a source of concern to community bankers. According to the Mercatus Center study, 70% of respondents reported that their banks' business activities have been affected by CFPB initiatives. 37% percent of respondents reported hiring additional legal or compliance personnel specifically in response to these initiatives. Finally, 78% of respondents anticipate that their customers will be affected by CFPB initiatives.

The Plan for Prosperity calls for legislation that would help insulate community banks from unnecessary CFPB regulatory burden. Specifically, the Plan would strengthen the accountability

of the CFPB by (i) reforming the structure of the CFPB so that it is governed by a five member commission rather than a single director; (ii) strengthening prudential regulatory review of CFPB rules by reforming the voting requirement for an FSOC veto from a two-thirds vote to a simple majority, excluding the CFPB Director; and (iii) change the standard to allow for a veto of a rule that "is inconsistent with the safe and sound operations of United States financial institutions" – a much more realistic standard than under current law. Combined, these changes would better protect community banks and the safety and soundness of the financial system.

Introduced Legislation

The provisions noted above are contained in the Consumer Financial Protection Safety and Soundness Improvement Act (H.R. 3193), sponsored by Rep. Sean Duffy (R-WI). We thank this committee and the House for passing this legislation.

Plan for Prosperity Solution: Modernize the Federal Reserve's Small Bank Holding Company Policy Statement

Bank regulators and the new Basel III standards continue to force many banks to bolster their capital levels. Closely held and non-publically traded community banks have extremely limited means to raise additional capital. However, there are reasonable ways to help address this challenge. The Plan for Prosperity calls for the Federal Reserve to revise the Small Bank Holding Company Policy Statement – a set of capital guidelines that have the force of law. The Policy Statement, which makes it easier for small bank holding companies to raise additional Tier 1 capital by issuing debt, would be revised to apply to both bank and thrift holding companies and to update the qualifying asset threshold from $500 million to $5 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage. This will help ease capital requirements for small bank and thrift holding companies.

Introduced Legislation

H.R. 3329, sponsored by Rep. Luetkemeyer (R-MO), would require the Federal Reserve to revise the Small Bank Holding Company Policy Statement by increasing the qualifying asset threshold from $500 million to $1 billion. We thank this committee for passing H.R. 3329 and urge prompt passage by the full House.

The CLEAR Relief Act (H.R. 1750) and the JOBS Act (H.R. 4304) would raise the asset threshold $5 billion.

FDIC Policy Should Encourage De Novo Community Bank Formation

As the number of community banks dwindles and more communities lose their local bank, ICBA is concerned that the FDIC has approved deposit insurance for only one de novo bank since 2010. This is a dramatic shift from many years of de novo bank formation averaging over 170 per year. The recent economic downturn and challenges specific to community banking, including narrowing margins, asset quality issues, and substantial compliance costs, have all been factors deterring the formation of de novo banks. However, ICBA believes that the FDIC's policy on de novo banks, which was adopted in 2009, has been too restrictive. The FDIC's one-size-fits-all policy effectively prohibits qualified individuals and communities across the United States from establishing de novo institutions.

The FDIC standard policy requires de novo applicants for deposit insurance to raise capital prior to opening that would be sufficient to maintain its leverage ratio at a minimum of 8% for the first three years of operation based on the pro forma financials and the business plan of the applicant. In addition, the institution is expected to present a business plan in its third year showing how it would maintain capital for years 4 through 7 of its operation.

ICBA supports a more flexible and tailored supervisory policy with regard to de novo banking applicants. Capital standards, exam schedules, and other supervisory requirements should be based on the pro forma risk profile and business plan of the applicant and not on a standard policy that applies to all de novo bank applicants.

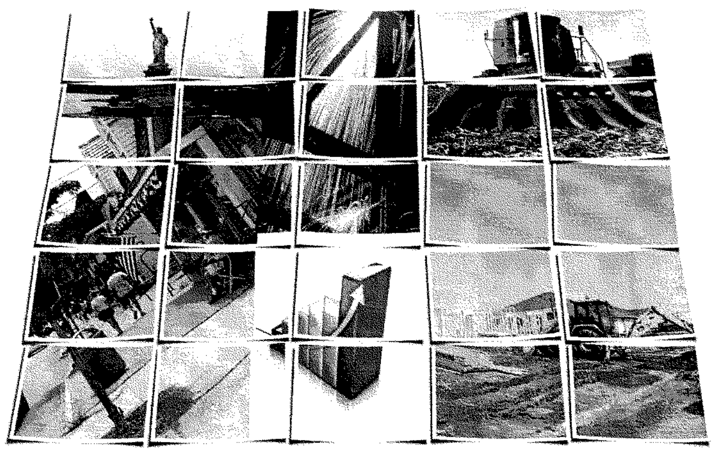
Closing

Left unaddressed, the increasing burden of regulation will discourage the chartering of new community banks and lead to further industry consolidation. Consolidation will lead to higher loan interest rates and fees for borrowers, lower rates paid on deposits, and fewer product choices – especially in the rural areas and small towns currently served by community banks. A more concentrated industry, dominated by a small number of too-big-to-fail banks, will jeopardize the safety and soundness of the financial system and expose taxpayers to the risk of additional costly bailouts. That's why it's so important to enact sensible regulatory reforms. We hope that ICBA's Plan for Prosperity will continue to serve as a guide to this committee. Thank you again for the opportunity to provide this written statement for the record. We look forward to continuing to work with this committee to craft urgently needed legislative solutions. We also thank you for emphasizing our concerns with the regulatory agencies.

Attachments

- **ICBA Plan for Prosperity**

Plan for Prosperity



A Regulatory Relief Agenda to Empower Local Communities

2013

Plan for Prosperity: A Regulatory Relief Agenda to Empower Local Communities

America's 7,000 community banks are vital to the prosperity of the U.S. economy, particularly in micropolitan and rural communities. Providing 60 percent of all small business loans under $1 million, as well as customized mortgage and consumer loans suited to the unique characteristics of their local communities, community banks are playing a vital role in ensuring the economic recovery is robust and broad based, reaching communities of all sizes and in every region of the country.

In order to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, community banks must be able to attract capital in a highly competitive environment. Regulation calibrated to the size, lower-risk profile, and traditional business model of community banks is critical to this objective. ICBA's Plan for Prosperity provides targeted regulatory relief that will allow community banks to thrive by doing what they do best – serving and growing their communities. By rebalancing unsustainable regulatory burden, the Plan will ensure that scarce capital and labor resources are used productively, not sunk into unnecessary compliance costs, allowing community banks to better focus on lending and investing that will directly improve the quality of life in our communities. Each provision of the Plan was selected with input from community bankers nationwide and crafted to preserve and strengthen consumer protections and safety and soundness.

The Plan is not a bill; it is a platform and set of legislative priorities positioned for advancement in Congress. The provisions could be introduced in Congress individually, collectively or configured in whatever fashion suits interested members of Congress. The Plan is a flexible, living document that can be adapted to a rapidly changing regulatory and legislative environment to maximize its influence and likelihood of enactment. Provisions of the Plan include:

Support for the Housing Recovery: Mortgage Reform For Community Banks. Provide community banks relief from certain mortgage regulations, especially for loans held in portfolio. When a community bank holds a loan in portfolio, it has a direct stake in the loan's performance and every incentive to ensure it is affordable and responsibly serviced. Relief would include: Providing "qualified mortgage" safe harbor status for loans originated and held in portfolio for the life of the loan by banks with less than $10 billion in assets, including balloon mortgages; exempting banks with assets below $10 billion from escrow requirements for loans held in portfolio; increasing the "small servicer" exemption threshold to 20,000 loans (up from 5,000); and reinstating the FIRREA exemption for independent appraisals for portfolio loans of $250,000 or less made by banks with assets below $10 billion.

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Strengthening Accountability in Bank Exams: A Workable Appeals Process. The trend toward oppressive, micromanaged regulatory exams is a concern to community bankers nationwide. An independent body would be created to receive, investigate, and resolve material complaints from banks in a timely and confidential manner. The goal is to hold examiners accountable and to prevent retribution against banks that file complaints.

Redundant Privacy Notices: Eliminate Annual Requirement. Eliminate the requirement that financial institutions mail annual privacy notices even when no change in policy has occurred. Financial institutions would still be required to notify their customers when they change their privacy policies, but when no change in policy has occurred, the annual notice provides no useful information to customers and is a needless expense.

Serving Local Governments: Community Bank Exemption from Municipal Advisor Registration. Exempt community bank employees from having to register as municipal advisors with the SEC and the Municipal Securities Rulemaking Board. Community banks provide traditional banking services to small municipal governments such as demand deposits, certificates of deposit, cash management services, loans and letters of credit. These activities are closely supervised by state and federal bank regulators. Municipal advisor registration and examination would pose a significant expense and regulatory burden for community banks without enhancing financial protections for municipal governments.

Creating a Voice for Community Banks: Treasury Assistant Secretary for Community Banks. Economic and banking policies have too often been made without the benefit of community bank input. An approach that takes into account the diversity and breadth of the financial services sector would significantly improve policy making. Creating an Assistant Secretary for Community Banks within the U.S. Treasury Department would ensure that the 7,000 + community banks across the country, including minority banks that lend in underserved markets, are given appropriate and balanced consideration in the policy making process.

Balanced Consumer Regulation: More Inclusive and Accountable CFPB Governance. Change the governance structure of the CFBP to a five-member commission rather than a single Director. Commissioners would be confirmed by the Senate to staggered five-year terms with no more than three commissioners affiliated with any one political party. This change will strengthen accountability and bring a diversity of views and professional backgrounds to decision-making at the CFPB. In addition, FSOC's review of CFPB rules should be strengthened by changing the vote required to veto a rule from an unreasonably high two-thirds vote to a simple majority, excluding the CFPB Director.

Relief from Accounting and Auditing Expenses: Publicly Traded Community Banks and Thrifts. Increase from $75 million in market capitalization to $350 million the exemption from internal control attestation requirements. Because community bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded community banks without creating more risk for investors. Separately, due to an inadvertent oversight in the recently-passed JOBS Act, thrift holding companies cannot take advantage of the increased shareholder threshold below which a bank or bank holding company may deregister with the SEC. Congress should correct this oversight by allowing thrift holding companies to use the new 1200 shareholder deregistration threshold.

Ensuring the Viability of Mutual Banks: New Charter Option and Relief from Dividend Restrictions. The OCC should be allowed to charter mutual national banks to provide flexibility for institutions to choose the charter that best suits their needs and the communities they serve. In addition, certain mutual holding companies – those that have public shareholders—should be allowed to pay dividends to their public shareholders without having to comply with numerous "dividend waiver" restrictions as required under a recent Federal Reserve rule. The Federal Reserve rule makes it difficult for mutual holding companies to attract investors to support their capital levels. Easier payment of dividends will ensure the viability of the mutual holding company form of organization.

Rigorous and Quantitative Justification of New Rules: Cost-Benefit Analysis. Provide that financial regulatory agencies cannot issue notices of proposed rulemakings unless they first determine that quantified costs are less than quantified benefits. The analysis must take into account the impact on the smallest banks which are disproportionately burdened by regulation because they lack the scale and the resources to absorb the associated compliance costs.
In addition, the agencies would be required to identify and assess available alternatives including modifications to existing regulations. They would also be required to ensure that proposed regulations are consistent with existing regulations, written in plain English, and easy to interpret.

Additional Capital for Small Bank Holding Companies: Modernizing the Federal Reserve's Policy Statement. Require the Federal Reserve to revise the Small Bank Holding Company Policy Statement – a set of capital guidelines that have the force of law. The Policy Statement, makes it easier for small bank holding companies to raise additional capital by issuing debt, would be revised to apply to both bank and thrift holding companies and to increase the qualifying asset threshold from $500 million to $5 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage. This will help ease capital requirements for small bank and thrift holding companies.

Cutting the Red Tape in Small Business Lending: Eliminate Data Collection. Exclude banks with assets below $10 billion from new small business data collection requirements. This provision, which requires the reporting of information regarding every small business loan application, falls disproportionately upon community banks that lack scale and compliance resources.

Facilitating Capital Formation: Modernize Subchapter S Constraints and Extend Loss Carryback. Subchapter S of the tax code should be updated to facilitate capital formation for community banks, particularly in light of higher capital requirements under the proposed Basel III capital standards. The limit on Subchapter S shareholders should be increased from 100 to 200; Subchapter S corporations should be allowed to issue preferred shares; and Subchapter S shares, both common and preferred, should be permitted to be held in individual retirement accounts (IRAs). These changes would better allow the nation's 2300 Subchapter S banks to raise capital and increase the flow of credit. In addition, banks with $15 billion or less in assets should be allowed to use a five-year net operating loss (NOL) carryback through 2014. This extension of the five-year NOL carryback is countercyclical and will support community bank capital and lending during economic downturns.

The Independent Community Bankers of America®, the nation's voice for nearly 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. For more information, visit www.icba.org.

MBa

MORTGAGE BANKERS ASSOCIATION

Mortgage Bankers Association
Statement for the Record

House Committee on Financial Services

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

April 8, 2014

The Mortgage Bankers Association appreciates this opportunity to submit a statement for the record for the hearing titled "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

A comprehensive review of the regulations, both the finalized rules and those on track toward completion, is both timely and necessary. Since enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the mortgage industry has become subject to the most far-reaching package of rules to impact the housing and real estate finance system in at least a generation. These rules have fundamentally altered consumers' options to obtain and maintain mortgage financing while having a profound impact on key aspects of our nation's primary and secondary mortgage markets.

Many of these rules have come online in recent months, while others present looming implementation challenges in the months ahead. The mortgage industry has spent much of the past year reviewing, understanding and then operationalizing these rules, building new policies and procedures, re-engineering loan processes, reprogramming mortgage origination systems, and training our personnel. These rules also require sweeping changes to the commercial/multifamily lending sector.

In reviewing these rules, it is important to understand that the housing market remains relatively weak and the opportunity for ordinary Americans to finance a home has diminished. Over the past several years, a key concern driving market weakness has been the levels of uncertainty in the regulatory landscape. Sales prices have increased in many areas across the country, pulling many homeowners above water for the first time in years. While the housing market is improving, data show the improvement is predominantly at the higher end of the market, with increasing activity in higher-priced homes while the lower end of the market is actually shrinking. Access to credit is clearly constrained with first-time and low- to moderate-income borrowers unable to qualify for a mortgage.

Furthermore, over the past three months, applications to buy homes have decreased, and are now running about 15 percent behind their pace of one year ago. The increase in mortgage rates has certainly been a factor, but the complications of the new regulatory regime are likely having an impact as well. MBA has indicated that originations for 2014 are likely to be lower than had been forecast just a few months ago, reflecting this new, weaker data.

In this environment, with so many new regulations impacting an already weak housing market, Congress should continue to focus attention on how these rules are impacting access to consumer credit.

MBA will focus its statement on aspects of three rules we believe will have the most detrimental effects on access to safe and affordable mortgage credit – potentially harming the very consumers they were designed to protect. Those rules are: the Consumer Financial Protection Bureau's Ability to Repay rule and its Qualified Mortgage (QM) standards, which took effect this January; the risk retention rules, which will impact both commercial and residential lending, and which are expected to be finalized later this year; and the Basel III impacts on Mortgage Servicing Rights and commercial real estate lending.

Ability to Repay

There is perhaps no more significant rule impacting mortgage lending than the Ability to Repay rule and its Qualified Mortgage standards

When this rule first took effect in January, MBA was pleased to testify before the Subcommittee on Financial Institutions on its expected impact. As MBA Vice Chairman Bill Emerson, the chief executive officer of Quicken Loans, noted at that hearing, MBA very much appreciated the CFPB's work in crafting these regulations. The Bureau's staff started with difficult and oftentimes ambiguous statutory provisions and, by listening to stakeholders and through their own hard work, created rules that are a substantial improvement over the Dodd-Frank framework.

Nevertheless, while the CFPB has done much to develop this rule, we remain concerned it will unduly tighten mortgage credit for a significant number of creditworthy families who seek to buy or refinance a home.

MBA believes the likelihood of widespread non-QM lending is very remote in the near term. In fact, the early data we are seeing reinforces this, with non-QM lending accounting for single digit shares of mortgage application volume from most lenders.

The risks of liability and protracted litigation are greatest for those loans where there is no presumption of compliance and there is a strong possibility of inconsistent case law muddying the legal waters for several years. Non-QM lending will likely occur only in these limited circumstances: (a) accidentally, where there has been a miscalculation of any of the myriad standards embedded in the rule, including the points and fees limit; (b) to the most qualified borrowers with very high credit quality and sufficient assets so any default risk is very low and the loans can be kept in a lender's portfolio; and (c) higher-risk borrowers who can nevertheless afford significantly higher rates.

To improve the Ability to Repay rule, MBA recommends that the CFPB make the following revisions:

1. *Establish cure procedures* – The CFPB should adopt rules allowing lenders to cure calculation errors and other processing mistakes made while attempting to meet the QM requirements. Without such procedures, lenders will be forced to avoid transactions at the boundaries of the points and fees cap, DTI limits and the APR-APOR spread, depriving many qualified borrowers of affordable, sustainable QM credit. Notably, the Home Ownership and Equity Protection Act (HOEPA) rules include a cure procedure that ensures prompt corrective action, provides more favorable loans for borrowers and avoids unnecessary loan costs.

2. *Establish a better process for providing written guidance* – Establish a process to provide timely, reliable written guidance with stakeholder input on regulatory requirements rather than forcing stakeholders to await publication of formal regulatory revisions and commentary. The absence of responsive, authoritative written guidance from the CFPB has resulted in inconsistent and understandably conservative guidance from investors. This lack of clarity, in turn, has harmed consumers by depriving them of beneficial loan features such as discount points.

3. *Increase the threshold for "smaller loans"* – Increase the threshold for "smaller loans" under the ATR rule to $200,000 (from $100,000) so that loans under $200,000 are subject to more workable points and fees limits that increase on a sliding scale as the loan amount decreases. Such a change will increase the availability of credit to first-time and moderate-income borrowers who seek smaller balance loans.

4. *Expand the safe harbor* – Expand the safe harbor to all QM loans or at least to include loans with APRs up to 2 percent above their comparable APORs. Fear of undue liability and associated litigation costs for ability to repay violations have led many lenders to confine their lending to QM safe harbor loans. Expansion or abolition of the threshold between QM safe harbor and QM rebuttable presumption loans would ensure that borrowers who qualify at higher rates are served by safe, sustainable, affordable QM loans.

5. *Treat all third party charges the same for purposes of the points and fees calculation* – The inclusion of bona fide third party charges to affiliates but not non-affiliates in the points and fees calculation lessens competition and will result in increased charges to consumers, increasing credit costs.

Finally, MBA calls on Congress to pass H.R. 3211, the Mortgage Choice Act, which would fix the way "points and fees" are calculated for purposes of meeting the QM's three percent cap. We are grateful to the many members of the Financial Services Committee who have introduced and cosponsored this legislation on a truly bipartisan basis. We are also grateful to Chairman Hensarling for including these important provisions in his broader housing finance bill, the PATH Act.

Risk Retention – Commercial and Residential Perspectives

Residential

While the Ability to Repay rule has been completed, Dodd-Frank's risk retention rules aren't expected to be finalized until later this year.

MBA has urged the six federal regulators responsible for promulgating the risk retention rule to align the QRM definition with the CFPB's QM definition.

Both QM and QRM have similar objectives: sustainable lending that benefits both consumers and investors. One seeks to design a sustainable mortgage as a means of satisfying the ability to repay requirements and the other provides an exception to the requirement for risk retention for less risky loan products. (Notably, Section 941 of the Dodd Frank Act, which establishes the QRM exemption, also requires that the QRM definition be no broader than the definition of QM.)

Considering these points, MBA shares the view of an array of stakeholders that the definitions under both these rules should be the same. We were gratified that the recent re-proposal of the Risk Retention rule offered synchronization of QRM and QM as the preferred approach. Notably, however, the proposal also offered an alternative that would require a minimum 30 percent down payment for purchase loans and a maximum 70 LTV for refinances to qualify. Comments on the rule made it clear that the preferred approach is supported by nearly every stakeholder in the consumer advocacy, lending and real estate communities while the alternative is vehemently opposed by these same groups.

There is no justification for disparate definitions of a sustainable loan under these two rules. In fact, such a discrepancy will only increase confusion and costs to consumers. Aligning the QRM and QM standards will ensure that strong incentives for safe and sound lending are in place, invite the return of private capital and bring lower mortgage rates to the widest array of qualified borrowers.

Commercial

In August 2013, the banking regulatory agencies issued a re-proposal of the April 2011 proposed risk retention rule. The re-proposal was responsive to many of MBA's initial concerns. For example, it eliminated the highly problematic Premium Cash Capture Reserve Account, which would have jeopardized the commercial mortgage-backed securities (CMBS) market by eliminating the financial incentive to issue CMBS. The re-proposal also provided for greater flexibility in the allocation of risk retention and for the first time prescribed a hold period (five years) for risk retention. Several components of the re-proposal, however, remain problematic and our recommendations are below:

1. MBA raised strong concerns about the proposed cash flow restrictions to be placed on horizontal risk retention holders. The eligible horizontal risk retention interest (EHRI) recovery percentage, as proposed, would severely limit cash flow to horizontal risk retention holders. Given the waterfall structure of CMBS cash flow, this provision is unworkable and should be withdrawn.
2. The agencies should allow additional flexibility in the risk retention structure by allowing the horizontal risk retention position to be split into senior and subordinate positions, in addition to the *pari passu* arrangement that would be permitted in the re-proposal. This would provide greater flexibility for existing market participants to assume the five percent horizontal risk retention position.
3. The underwriting parameters for a "qualified commercial real estate loan" should be expanded to include, among other things, mortgages with a 30-year amortization period, adding consistency to existing lending practices.
4. Given their very strong underwriting characteristics and strong market performance, single asset and single borrower CMBS should be excluded from risk retention.
5. CMBS loan documents, such as the Pooling and Servicing Agreement (PSA), should specify the quorum necessary for bond holders to vote to replace the special servicer, rather than specify a threshold in the regulation.

Basel III – Mortgage Servicing Rights

MBA is deeply concerned about the treatment of mortgage servicing rights under the Basel III rules promulgated and finalized by the FDIC, OCC, and Federal Reserve on July 2, 2013. The Final Rule became effective on January 1, 2014, but many sections have separate phase-in rules and some provisions requiring additional rule making. The structure of mortgage servicing in the United States is unique, as is the importance of MSRs to banks, which is why MBA believes the then existing regulatory capital treatment of MSRs was appropriate and that the Basel III limits on MSRs should not be applied in the United States.

Despite these concerns, U.S. bank regulators elected to move forward with their proposed treatment of MSRs, and the result has harmed the industry and the consumers they service. Already we are seeing

the effects: rising costs, greater barriers to entry, movement of servicing to non-depository institutions, and reduced competition.

MBA believes the Basel III rules, as they relate to MSRs, need to be revisited in the near future in order to reduce their negative impact. Specifically, MBA recommends:

1. Revision of the cap. MSRs are currently limited by a 10 percent cap. The MSR cap before deduction from the common equity component should be raised to a higher level. MBA recommends the use of at least a 25 percent cap for MSRs on the books of banks. The present capital rules allow depositories with a thrift charter a higher threshold than those with a bank charter in order to further promote mortgage lending by savings and loan associations. Basel III should continue this important differential. MBA therefore a 50 percent cap for MSRs on the books of thrifts and savings and loans.
2. Basel III also limits the aggregate of MSRs, deferred tax assets, and equity interests in unconsolidated entities to 15 percent of the common equity component of tier 1 capital. MBA believes that MSRs should be excluded from this limit because, unlike deferred tax assets and equity interests in unconsolidated entities, MSRs have significant, predicable cash flows and are readily marketable.
3. Servicing of commercial mortgages and MBS should be carved out completely from the application of the Basel III limits on servicing because of the reduced prepayment risk and the fact that servicing fees are received on assets in default.

Basel III – Commercial Real Estate Perspective

Basel III adds a new layer of regulation to many aspects of bank operations, including commercial real estate lending. From the commercial real estate finance perspective, MBA is working with members to identify and address areas of the final rule that require greater specificity and clarification in order to be correctly implemented. As a supplemental rulemaking to Basel III, in January 2014, the banking agencies released a proposed rule that creates a new bank liquidity measure – the liquidity coverage ratio (LCR). The LCR is intended to ensure that large banks hold sufficient stocks of "high quality liquid assets" to survive a specified liquidity stress scenario. MBA has raised strong concerns that the proposed LCR could negatively impact bank appetite for commercial real estate construction lending and acquisition credit facilities.

Conclusion

MBA appreciates the Financial Services Committee's continued and bipartisan interest in the work being done by federal regulators to implement the Dodd-Frank Act, our industry's focus on compliance with the new regulations, and the effects these rules are having on the consumers we serve.

We all want rules that work. That means rules that protect consumers while ensuring that as many qualified consumers as possible have access to mortgage lending under affordable terms. It means rules that give lenders legal certainty and a clear roadmap on how to comply. And it means rules that help our economy grow and create jobs and housing opportunities.

In the months ahead, MBA will continue to provide policymakers with data demonstrating the impact of these rules. We look forward to continuing our work with the Financial Services Committee, as well as the federal banking regulators and all other stakeholders, on these important issues.

Statement of the National Automobile Dealers Association
A Hearing Entitled
"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"
Before the House Financial Services Committee
April 8, 2014

Mr. Chairman, thank you for the opportunity to submit the comments of the National Automobile Dealers Association (NADA) in the hearing record. NADA is a national trade association that represents the interests of 16,000 franchised new car and truck dealer members. NADA members are primarily engaged in the retail sale and lease of new and used motor vehicles, and also engage in automotive service, repairs, and parts sales. Last year America's franchised new car and truck dealers collectively employed nearly one million individuals and sold or leased approximately 15.6 million new cars and light duty trucks. NADA members operate in every congressional district in the country, and the majority of our members are small businesses as defined by the Small Business Administration.

Overview

The current dealer-assisted financing system provides broad credit availability and low credit prices for consumers. Among other things, an automobile dealer's ability to "meet or beat" its competitors' rates produces vigorous marketplace competition that benefits consumers. A majority of car buyers choose to finance their purchases through optional, indirect financing at dealerships.[1]

The Consumer Financial Protection Bureau (CFPB or the Bureau) released guidance on March 21, 2013 (the CFPB Guidance), without prior notice or an opportunity for public comment, alleging a "significant risk" that dealer-assisted auto financing has a "disparate impact" on the price of credit for consumers in protected classes. This controversial Guidance pushes auto finance sources into changing the way they compensate dealers to a flat fee approach and, in doing so, threatens to eliminate dealer flexibility to offer consumers a discounted interest rate when arranging auto financing.

The CFPB made this "disparate impact" allegation without providing any supporting public analysis or documentation. Careful study of the CFPB Guidance, however, reveals that the CFPB's attempt to regulate auto dealers by pressuring lenders to change their business practices (1) does not address the disparate impact problem the CFPB alleges; and (2) will likely raise credit costs and decrease access to credit for consumers. In addition to the harm the CFPB's new policies will cause consumers, Congress should take notice that the CFPB is bringing about these fundamental and detrimental changes via "guidance," thus avoiding both the rulemaking process and coordination with the federal agencies that Congress vested with exclusive federal authority

[1] Currently dealers have the ability to "meet or beat" the interest rates offered by their competitors which frequently results in consumers getting lower rates than those offered by banks, credit unions, *as well as other dealers*. This intense market competition generates downward pressure on all prices as other lenders in the market know the dealer can negotiate down to win the sale. As a result, the current system yields credit that is widely available and very competitively priced. (See attached infographic.)

over motor vehicle dealers.[2] Congress specifically designed the rulemaking process to ensure that new regulations benefit from public input and scrutiny before they are issued.

Discrimination in any market – including indirect auto financing – has no place in society, and NADA fully supports the efforts of the CFPB and other federal agencies to eliminate it from the marketplace. However, as it relates to unintentional disparate impact discrimination, it is important to recognize that the efforts of federal regulators can only be successful if they engage in several essential steps. These steps include the following:

- regulators must understand the market they are examining;
- regulators must develop appropriate methodologies for accurately measuring whether disparate impact exists in that market; and
- to the extent that disparate impact is found to be present, regulators must address it in a manner that both accomplishes its purpose and is consistent with the interests of consumers.

Unfortunately, the CFPB has not followed any of the essential steps described above.

Congress is still awaiting critical details about the CFPB's disparate impact testing methodology. The CFPB's lack of transparency has deprived stakeholders of a meaningful opportunity to determine if there are flaws in its initiative. As noted by Senator Jeanne Shaheen (D-NH), it is critically important that the CFPB's efforts in this regard are "done in a fair and transparent way that gives the public an opportunity to weigh in."[3]

As recognized and demanded on several occasions by bipartisan members of the House and Senate, the CFPB needs to identify the complete methodology it employs to measure whether statistically significant disparate impact exists in an auto lender's portfolio. Otherwise, one can have little confidence that the Bureau's model is producing reliable results. This requires, among other things, that the Bureau fully account for neutral, legitimate factors that affect dealer compensation which are completely unrelated to a consumer's background.

It is also essential that the Congress fully consider the assumptions that support the statement in the CFPB Guidance that auto lenders can ensure they are complying with the Equal Credit Opportunity Act (ECOA) by "eliminating dealer discretion" through the adoption of an alternative form of dealer compensation such as the payment of "a flat fee per transaction" or similar approach. This compliance step is flawed in two significant regards.

First, a broad industry move by finance sources to eliminate dealer discretion through the payment of flat fees will, quite simply, fail to eliminate dealer discretion. This is because dealers typically sell credit contracts to a variety of finance sources. Each finance source would set its own flat fee, and dealers would have discretion to select the finance source to which they sell the

[2] Section 1029 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) precludes the CFPB from exercising any authority over motor vehicle dealers engaged in indirect financing and further provides that the federal agencies who could exercise jurisdiction over dealers prior to the enactment of section 1029 continue to have authority over dealers.

[3] Press release by Senator Shaheen, *"Portman, Shaheen Lead Bipartisan Group of Senators in Pushing for CFPB Transparency Regarding New Policy Guidance That Could Harm Auto Dealers and Consumers,"* Oct. 30, 2013.

contract. While this may address the fair lending risk for individual finance sources, it will not address whatever fair lending risk may exist for the consumer.

Second, a broad industry adoption of flat fees would remove the ability of dealers to cut into their own retail margins and win a customer's business by "meeting or beating" a competitive offer available to the consumer from another financing source. This will weaken competition and, in turn, drive up the cost of credit. This would adversely affect consumers, particularly credit challenged consumers who could lose access to conventional financing for their transportation needs. Democrats and Republicans in Congress have expressed concerns about this, and we hope the Bureau will respond to those concerns by analyzing this undesirable consequence.

These significant flaws in the CFPB's policy could have been avoided if the Bureau had employed a process that was data- and market-driven and transparent. Nearly all that is known on the record about the Bureau's disparate impact initiative is what has been derived from congressional oversight. Accordingly, continued oversight by the House Financial Services Committee is critical to protect consumers and small businesses.

The Avoidance of the Rulemaking Process

Through its Guidance, the CFPB is attempting to significantly alter the operation of a large and efficient market without following the standard rulemaking process and without considering the stakeholder input, public comments, and cost/benefit analysis that are associated with it. By avoiding the rulemaking process, the CFPB did not have to:

- reveal the methodology it employs to determine whether disparate impact discrimination exists;
- convene a panel to ascertain what impact its new policies would have on small business;
- give the public and affected stakeholders an opportunity to comment on the record; and
- conduct a cost/benefit analysis.

A CFPB official has characterized the CFPB Guidance as "simply [a] restatement of existing law."[4] However, the CFPB's Guidance could, in fact, fundamentally change how vehicles are financed. The regulatory uncertainty that the Guidance has produced within the vehicle financing industry and the numerous unanswered questions from Congress and others concerning the Guidance show that it is much more than a restatement of existing law.

The Lack of Transparency

The CFPB has failed to provide analysis to substantiate its Guidance despite bipartisan calls for transparency from Congress. Since a valid showing of "disparate impact" is entirely based on a statistical analysis of past transactions, Members of Congress have asked the Bureau which statistical controls it employs to ensure that customers from different groups who are being compared are "similarly situated." However, even with congressional oversight hearings and

[4] "*The Consumer Financial Protection Bureau's Semi-Annual Report to Congress: Hearing before the Senate Banking, House and Urban Affairs Committee*, 113[th] Cong., 1[st] Sess. 17 (2013).

eleven congressional letters[5] sent by Democrats and Republicans alike, the CFPB has failed to answer this and other essential questions. As an example, in one reply to Congress, the Bureau stated the analytical controls it uses are "appropriate"[6] – but did not identify the specific controls it employs. Since the CFPB has still not provided this essential information to substantiate its claims, there is no way to conclude whether its methods for measuring disparate impact are reliable.

Another area where Congress has inquired but not received complete answers from the Bureau is the methodology it employs to identify members of a protected class, which is a prerequisite for a disparate impact claim. Unlike in the mortgage arena, information identifying a person's race, gender, or national origin is not collected on an auto loan application. The CFPB uses a proxy methodology that assigns a *probability* that a particular applicant is of a certain race, gender, or ethnic background. The accuracy of this proxy data is crucial. If the person whom the CFPB claims is a victim of disparate impact is not in fact a member of a protected class, discrimination has not occurred. On October 30, 2013, the CFPB was asked by 22 Senators to "provide the quantitative degree of accuracy that applies to [the proxy] methodology for each group of consumers the Bureau has examined."[7] No answer to this request was provided.

The Ally Settlement

The CFPB's failure to provide an answer to the Senators on the accuracy of its proxy data is troubling, as it could result in non-minorities being improperly compensated for disparate impact discrimination. On December 20, 2013, the CFPB announced consent agreements that the CFPB and the Department of Justice (DOJ) entered into with Ally Financial, Inc. and Ally Bank (Ally), a major indirect auto lender, in a case which involved allegations of disparate impact discrimination. The CFPB issued a press release that day stating "[t]he CFPB and DOJ determined that more than 235,000 minority borrowers paid higher interest rates for their auto loans between April 2011 and December 2013 because of Ally's discriminatory pricing system."[8] Yet, according to aspects of the proxy methodology the CFPB has chosen to reveal to Congress, the "235,000 minority borrowers" exist only as a probability, despite the CFPB presenting this figure in its press release as the *actual* number of minority consumers who were allegedly harmed. The CFPB's assertions of fact in its press release demonstrate why it is important for the CFPB to reveal the accuracy of the proxy methodology supporting its assertions.

The Ally consent agreement is not proof that the CFPB's drive to eliminate a dealer's ability to discount credit in the showroom is justified. Based on facts listed below, the Ally consent agreement appears simply to be a rational business decision made in the current regulatory atmosphere. We urge the Committee to consider the following facts:

- Ally did not admit to any findings or conclusions in the consent order, other than that the CFPB had jurisdiction over Ally.

[5] These letters can be accessed at: http://www.nada.org/legislativeaffairs/economy-financial/cfpb/default
[6] Letter from the Hon. Richard Cordray, Director, CFPB, to Rep. Terri Sewell (D-AL) (June 20, 2013).
[7] Letter from Senators Portman, Shaheen et. al to the Hon. Richard Cordray, Director, CFPB (Oct. 30, 2013).
[8] Press Release by the CFPB, *"CFPB and DOJ Order Ally to Pay $80 Million to Consumers Harmed by Discriminatory Auto Loan Pricing,"* (Dec. 20, 2013).

- The case against Ally was based entirely on statistics and methodologies which have not been revealed publicly or to Congress. The public still does not know whether the Bureau takes into account legitimate factors that can affect finance rates – for example, a dealer's ability to lower its interest rate to meet a competitive offer or the customer's monthly budget needs. Indeed, Ally released a statement when the consent order was announced saying that "based on the company's analysis of its business, it does not believe that there is measurable discrimination by auto dealers."[9] This statement is evidence that CFPB did not perform a comprehensive regression analysis (i.e., one that includes all the relevant factors, not simply those chosen by the CFPB).
- Three days after the Ally consent order, the Federal Reserve Board approved Ally's application to become a financial holding company, enabling Ally to continue offering insurance products and other services that Ally might have been forced to discontinue. According to the *Wall Street Journal*, "Standard & Poor's Ratings Services… warned it would potentially lower the company's ratings if it failed to secure financial holding company status."[10]
- According to *Automotive News*, "the CFPB was one of a number of regulators that had input on the Federal Reserve's decision on financial holding company status." An Ally official stated that "[n]o investor publically was going to invest in us unless we got financial holding company status. And we could not do that without coming to terms with the CFPB."[11]
- On March 27, 2013, Ally announced an initial public offering where the U.S. government "would sell the bulk of its stake in the company."[12] (At the time of the consent order, the U.S. government had a 64 percent controlling interest in Ally.)

The Unknown Costs of the CFPB's Drive to Eliminate Dealer "Meet or Beat" Financing

Section 1022 of the Dodd-Frank Act requires the CFPB to consider, when issuing a rule, the potential benefits and costs (including the potential reduction of consumer access to financial products and services) that could be caused by such a rule. One consequence of its avoiding the rulemaking process is that the CFPB avoids having to conduct, and does not benefit from, a study into the potential impact its new policy would have on consumers. In response to a letter sent by 22 Senators, the CFPB acknowledged that it never studied how eliminating a dealer's ability to discount credit would affect the cost of credit paid by consumers.[13] Reducing a strong competitive force from the vehicle financing marketplace will likely raise the cost of credit for consumers. Moreover, according to Fitch Ratings, the CFPB's drive to eliminate or severely limit "meet or beat" financing offered by auto dealers "will likely raise lender regulatory costs in 2014."[14]

Together, the weakening of competition and higher regulatory costs can be expected to result in higher credit costs for consumers. And, most troubling, the CFPB's actions could

[9] Ally Financial Statement on Auto Financing Consent Orders, Dec. 20, 2013.
[10] Andrew Johnson, *"Ally Receives Fed Approval for Financial Holding Company Status,"* Wall St. Journal, Dec. 23, 2013.
[11] Jim Henry, *"Ally won't be a 'Trojan horse' -- Lender sticks with dealer reserve, defies CFPB,"* Feb. 3, 2014.
[12] Tanya Agrawal, *"U.S. government to sell most of Ally Financial stake in IPO,"* Reuters, Mar. 27, 2014.
[13] Letter from the Hon. Richard Cordray, Director, CFPB to Senators Portman (R-OH) and Shaheen (D-NH) (Nov. 4, 2013).
[14] *"Fitch: CFPB Review of Auto Dealer Markups May Raise Lender Cost,"* Reuters, Jan. 16, 2014.

disproportionally hurt consumers with less-than-perfect credit since those customers will be less able to afford any higher rates and will therefore have even more limited options to buy a car or truck to meet their work and family needs.

The Assertion That the CFPB is Not Pushing the Industry to Flat Fees

The CFPB claims that it is not pushing the industry to flat fees, and in support of that claim it cites the existence of another compliance option in its Guidance: constraining dealer discretion accompanied by monitoring. In fact, the CFPB makes actual implementation of this latter option – constraining dealer discretion and monitoring – highly impractical. This option involves "imposing controls" on dealer reserve and then monitoring dealer behavior to ensure that those controls work. However, there are several problems for a lender with this option:

- First, the CFPB refuses to explain the rules for monitoring – that is, the Bureau will not tell lenders how to ensure that they are comparing "apples to apples." Many aspects of a vehicle financing transaction have nothing to do with the background of the borrower, and these variables could lead to differentials in the amount of compensation a dealer gets paid for originating the financing. These include factors such as:
    - borrower creditworthiness;
    - the amount financed;
    - the presence of a competing offer from another financing source;
    - the length of the loan; and
    - the presence of a manufacturer subvention of the rate (for example, a special promotional program on a certain model vehicle).

  If neutral, business-related factors such as these are the reason why the amount of a dealer's finance compensation varies from consumer to consumer, there is no unlawful discrimination. Hence, to do a proper comparison, these variables need to be held constant as part of the CFPB's analysis. But the CFPB will not let lenders know which factors should be held constant in completing a disparate impact review.

- Second, the CFPB still refuses to divulge the numerical basis point threshold at which the Bureau concludes that statistically significant pricing disparities exist. The CFPB apparently wants lenders to monitor dealer behavior without stating at what threshold disparate impact begins.

The Bureau's Guidance requires indirect auto lenders to guess at what controls and thresholds the CFPB would find appropriate. This lack of clarity indicates that there really is no safe harbor that can be achieved through "monitoring." Moreover, the CFPB has stated that the analytical controls necessary to measure disparate impact are to be determined on a "case by case"[15] basis which is contrary to the intent of "guidance" meant to govern the behavior of an entire industry. Indeed, the CFPB has not offered one example of a discretionary dealer compensation approach that indirect finance sources can adopt which is consistent with its March 2013 Guidance.

[15] Letter from the Hon. Richard Cordray to Rep. Colleen Hanabusa (D-HI) 3 (Feb. 6, 2014).

Since CFPB refuses to tell lenders what to monitor and how, and the only other compliance option it proffers is a flat fee approach,[16] the only logical conclusion a reasonable person can draw from the March 2013 Guidance is that this is the only compensation model that a finance source can adopt that will withstand CFPB scrutiny. Nothing in the Equal Credit Opportunity Act or its implementing regulation, Regulation B, requires the adoption of this compensation model as the sole means of complying with its mandates.

NADA's "Better Approach"

Despite the fact that the CFPB's "disparate impact" allegations are unexplained and unsubstantiated, in January 2014, NADA released its *Fair Credit Compliance Policy & Program* (the "NADA Program") to assist its members in addressing even the possibility of retail level discrimination in dealer-assisted financing. And, unlike the CFPB's approach, the NADA Program not only actually addresses the possibility of disparate impact, it does so in a way that is both pro-consumer and pro-competitive.[17]

It is important to note that the NADA Program (1) is entirely voluntary, (2) has not been formally adopted by any federal agency as a means of complying with the ECOA, and (3) is not a "safe harbor" for those who elect to adopt it. These important caveats aside, the NADA Program provides a very valuable resource for our members.

First, it allows the dealer to effectively manage the discretion that it exercises by adopting a compliance approach that the DOJ embraced in 2007 in two consent orders. These orders were entered into with dealers to resolve allegations of unlawful discrimination.

While the details of the Program are comprehensive, the basic framework is simple:

- A dealer who adopts the Program establishes a "Standard Dealer Participation Rate" – that is, a standard retail margin – for its dealership;
- In each and every transaction, the dealer adds the Standard Dealer Participation Rate to the bank or finance company wholesale buy rate to establish the retail APR that the dealer offers to all prospective customers; and
- The Standard Dealer Participation Rate, which would generally be a set number of basis points, is the same for every deal and its amount is determined by the individual dealer.

In its 2007 consent orders, the DOJ prudently recognized that stopping there would deprive consumers of the ability to obtain a lower, discounted rate from the dealer when there is a legitimate business reason for the lower rate, i.e., a reason that is unrelated to the customer's background. (In contrast, the CFPB's Guidance would eliminate a customer's ability to negotiate a lower interest rate in the showroom.) Accordingly, the DOJ, in its consent orders, and NADA, in its Program, allow for a downward deviation from the Standard Dealer Participation Rate – but

[16] CFPB officials have indicated that a flat percentage of the amount financed or a hybrid coupled with a flat fee per transaction would be acceptable; however, these are just variations of a flat fee.
[17] A copy of the NADA Program can be found at: www.nada.org/faircredit. This publication provides an overview of the ECOA issues and a comprehensive program template that a dealer can adopt to strengthen its compliance with ECOA (along with detailed implementation instructions).

only if one of seven good faith, pro-competitive situations is present. Examples of these pro-competitive situations include where the consumer has access to a more competitive rate from another dealer or lender or where the consumer has a budget constraint. Thus, the NADA Program addresses fair credit concerns by promoting a standardized approach that a dealer can adopt to determine its retail margin while preserving sufficient flexibility to allow consumers to benefit from the overwhelming competitive forces that exist in today's auto financing marketplace.

The NADA Program follows other aspects of the DOJ consent orders as well. For example, under the Program the dealer executes a form indicating whether the Standard Dealer Participation Rate or a lower dealer participation rate was included in a credit offer to a consumer. If a lower rate was included, it indicates the allowable reason for deviation that applies. And, the dealer records this determination for every deal.

In addition, as with any sound regulatory compliance program, the NADA Program requires a comprehensive set of procedures to effectively carry it out. This includes responsibilities related to training, document review and retention, monitoring, auditing, reporting, coordination, and oversight. In this way, the NADA Program – while completely modeled on the DOJ consent orders – actually contains procedures that are more robust.

While there is no perfect solution to the task of effectively managing discretion, the NADA Program can set a dealer on a clear path towards addressing fair credit concerns at the retail level. Accordingly, the NADA Program should be of benefit to all of the parties to an indirect vehicle financing transaction – consumers, dealers, and finance sources alike.

Pushing the Industry Toward Flat Fees by "Portfolio Monitoring"

Under its 2013 Guidance, the CFPB expects lenders who retain a discretionary dealer compensation system to monitor for potential fair credit violations on both a dealer-specific and portfolio-wide basis. Monitoring on a portfolio-wide basis is problematic, as it could suggest that there is alleged pricing discrimination even when no statistically significant pricing differentials are found to exist in the credit contracts purchased from each of that lender's dealer clients.

For example, assume that a dealer in Maine (Dealer A), which operates in an area that primarily consists of non-minority customers, assesses its local market conditions and charges 70 basis points in dealer participation on each and every auto financing transaction that it arranges for consumers, while a dealer in Hawaii (Dealer B), which operates in an area that primarily consists of minority customers, charges 95 basis points on each transaction. Because each dealer charged their respective customers the exact same amount for the services they provide, neither Dealer A nor Dealer B engaged in any form of discrimination. However, if a bank buys paper from both these dealers and monitors these transactions, it will find that while no pricing disparities exist at the retail level, pricing disparities nevertheless exist within its own portfolio. Such a distortion, *which the CFPB maintains must be avoided even if disparate impact is found not to be present at the retail level,*[18] has no support in public policy and is a further (and, indeed, a dispositive)

[18] See *Kate Davidson, Officials: Scrutiny of auto loans a big priority for CFPB and Justice,*" Politico Pro, Apr. 14, 2014 ("While CFPB Director Richard Cordray has said the NADA initiative is encouraging, Rebecca Gelfond, CFPB's deputy fair lending director, warned that the program is "a dealer-level response. The concern is that people

example of how the CFPB has provided finance sources with only one viable path to meeting its enforcement expectations – the adoption of a flat fee or other non-discretionary payment mechanism that does not require portfolio monitoring. Stated differently, because retail margins necessarily differ based on local market conditions and because the demographics of the populations that dealers serve also differ, pricing disparities in a finance source's portfolio are inevitable even when the finance source finds no unexplained pricing disparities at the retail level. This creates significant – and completely unjustified – liability exposure for finance sources that is inconsistent with the language and intent of the Equal Credit Opportunity Act.

Rebuttal of Reports by the Center for Responsible Lending

In 2011 and 2014, the Center for Responsible Lending, a group affiliated with economic competitors of auto dealers, released two reports attacking the indirect financing model. The purpose of these reports apparently is to advocate for more government regulation on automobile dealers. Because some Members of Congress have relied on the erroneous conclusions and flawed methodology found in these reports, we have attached and respectfully ask the Chairman to include NADA's rebuttals to these reports in the hearing record.

Conclusion

The indirect vehicle financing model is extraordinarily efficient, competitive and provides access to affordable credit to consumers in all credit tiers. Competition is currently fostered by, among other things, the ability of dealers to "meet or beat" the best interest rate offer that consumers can secure from other creditors, such as a bank, a credit union, or another dealer.

The CFPB is pressuring finance sources to eliminate a dealer's ability to discount credit in the showroom and replace it with a flat fee compensation model, thus eliminating the "meet or beat" dynamic that is critical to vigorous competition in the auto finance marketplace. What is most ironic is that the CFPB's push for a flat fee approach is being made in the name of addressing fair credit risk when that approach simply does not accomplish the Bureau's goal. Whatever fair credit risk exists with discretion in the current system will still exist under a flat fee approach, because dealers would retain discretion under a flat fee model to choose the lender to whom they assign financing. A better approach that both directly addresses fair credit risk and preserves market flexibility and competition for the benefit of the consumer is embodied in the NADA Fair Credit Compliance Program. We urge Congress to explore ways of encouraging greater consideration of this model.

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might assume that the dealer solution would also be a solution at the lender level," Gelfond said at a Consumer Bankers Association conference in Maryland. "I don't think that lenders should be making that assumption").

CRL's 2011 Analysis of Dealer-Assisted Financing is Flawed and Untrue

In 2011 the Center for Responsible Lending (CRL) issued a report, "Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses," that makes false and misleading claims about dealer-assisted automobile financing. A full review reveals that not one chart in the entire report accurately reflects the facts. The CRL report also contains significant factual errors and flaws; wrongly concludes that the compensation dealers receive for assisting their customers to obtain auto loans is an "overcharge"; and omits key data that demonstrates dealer-assisted financing saves consumers money.[1] As a result, the report's conclusions are neither valid nor credible.

The CRL report contains significant factual errors and flaws. The CRL claim that dealer-assisted financing resulted in an estimated $25.8 billion overcharge to consumers in 2009 is based on an erroneous assumption that consumers can qualify and access the wholesale/"buy" rate from a lender. Dealers, as well as other retailers, obtain products (in this case, credit) at a wholesale rate and include a retail margin in the price after absorbing the processing costs to market and deliver financing to consumers. Similarly, banks and credit unions do not lend to consumers at their cost of funds.

CRL also alleges that dealer compensation in the subprime arena causes higher levels of defaults and repossessions, yet the CRL fails to establish a causal relationship between dealer compensation and defaults. Among other flaws, the report appears to arrive at the conclusion of causation without controlling for creditworthiness, thereby rendering its entire analysis meaningless.

The CRL report fails to demonstrate that consumers who choose dealer-assisted financing actually pay more for financing than they would pay if they obtained financing from a bank or credit union. CRL alleges a $25.8 billion overcharge, claiming dealer-assisted financing "lead[s] to more expensive loans," without providing *any* evidence that dealer-assisted financing is more expensive than auto financing available from banks or credit unions. The data is also highly suspect, such as CRL's contention that the average dealer compensation earned in subprime auto loans is 5.04%. It is difficult to imagine how an average amount of dealer participation could come anywhere close to that level when every finance source studied capped dealer compensation per transaction at no more than 2.5%.

The CRL report omits key data that actually provides evidence that dealer-assisted financing saves consumers money. Evidence on the relative cost of dealer-assisted financing compared to retail vehicle financing offered directly by banks and credit unions suggests that dealer-assisted financing increases consumer choice and competition and that customers save billions of dollars a year financing their vehicle purchases through dealerships. In fact, by using the report's own analytical approach, their data suggests that from 2008 to 2010 consumers saved over $21 billion on new car purchases alone using dealership financing. In addition, actual transactional data demonstrates that dealers offer consumers retail finance rates that, on average, are more competitive than the retail rates offered by direct lending sources.

Conclusion. Amid vigorous competition by banks and credit unions that lend directly to consumers, approximately 80 percent of car buyers choose to finance their purchases through dealerships via optional, indirect financing. Since dealers provide affordable vehicle financing to a larger pool of consumers than any other lender, it is essential that dealer-assisted financing and affordable consumer credit is preserved.

February 24, 2014

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[1] For a detailed rebuttal of the CRL report, see NADA's March 30, 2012 Comments to the FTC's Motor Vehicle Roundtables at Appendix A (available at http://www.ftc.gov/sites/default/files/documents/public_comments/public-roundtables-protecting-consumers-sale-and-leasing-motor-vehicles-project-no.p104811-00105/00105-82871.pdf)

CRL's Flawed 2014 Report on Auto Financing

Recommendations Would Increase Consumers' Cost of Auto Financing

On January 23, 2014, the Center for Responsible Lending (CRL) released *Non-Negotiable*, a report that relies on flawed methodology to argue that financing offered by automobile dealers that allows them to "meet or beat" competing financing offers should be eliminated. "Meet or beat" financing lowers credit costs for all consumers by forcing banks and credit unions to offer competitive rates or risk being undercut by a dealer. The report has no credibility for the following reasons:

CRL Admits Its Methodology Is Flawed. The report makes inflammatory allegations by erroneously claiming that people of color paid higher annual percentage rates for auto loans despite the fact that they reportedly negotiated their rates more often than their non-minority counterparts. However, the report itself concedes it does not "hold all factors that may influence interest rate pricing as constant."[1] The report goes on to admit that CRL did "not run regressions to determine the statistical significance of the different factors, including race and ethnicity."[2] As a result, the statistical significance – or the probability that an effect is not due to chance alone – is unknown. To draw a valid connection between a rate, a consumer's background, and the degree of negotiation, the report should have held constant all other factors that influence interest rates. Failing to do so renders any comparisons based on APRs statistically invalid.

Most fundamentally, the Report Does Not Control for Creditworthiness. Any statistically valid study of credit pricing must compare customers who were similarly situated and, at a minimum, must take into account their creditworthiness. But CRL's report did not consider creditworthiness; indeed, its analysis included minority respondents who admittedly (1) had "poorer credit than whites," (2) had lower incomes, (3) purchased a higher percentage of used cars, and (4) borrowed more on average than the non-minority respondents.[3] Despite all these differences, CRL erroneously attributes the higher APRs reportedly paid by the minority respondents to unintentional dealership discrimination rather than to any other neutral differences. CRL simply ignores the fact that borrowers with "poorer credit" – regardless of their background – will predictably and understandably pay higher rates than more-creditworthy borrowers.

The Report Is Not Based on Data. The report relies on a questionable phone survey that asked participants to recall details such as "trade-in allowance" and "down payment" for transactions that occurred as long as six years ago. If survey participants didn't recall an answer, the survey accepted "their best guess."[4] Anecdotes that are based a guesses by respondents as to what happened six years ago are not data and provide no basis for the incendiary allegations that the report makes.

Conclusion. Although the report is entirely flawed and even acknowledges that its results "do not necessarily demonstrate discrimination," it nonetheless concludes that finance sources should pay dealers flat fees and should not permit dealers to discount those fees. This, however, would eliminate a dealer's ability to cut into its own retail margin to "meet or beat" a competing loan offer by a bank or credit union for the benefit of consumers.[5] Given its massive flaws and since its recommendations would result in both (1) less competition among auto lenders and (2) an increase in the cost of credit for consumers, CRL's report needs much more scrutiny and review before any policy decision is made to rely on it.

February 27, 2014

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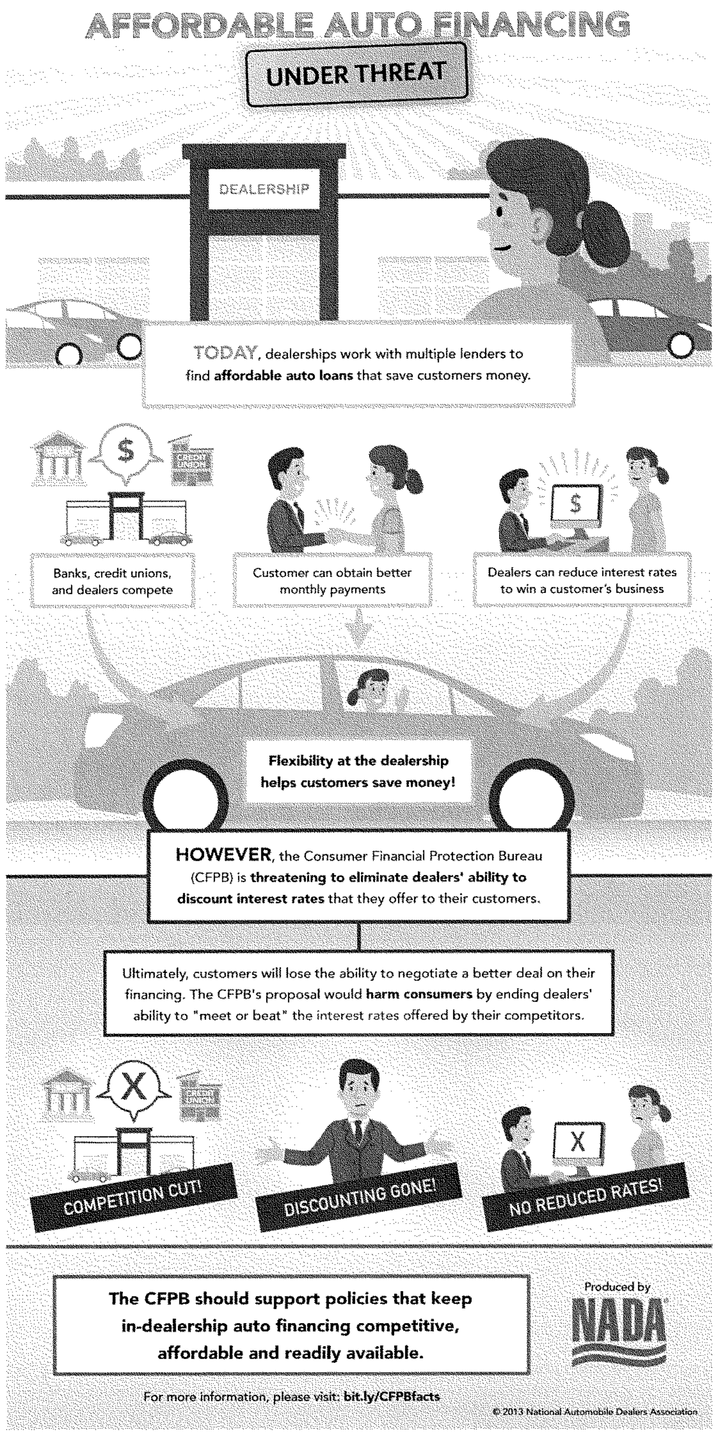
[1] Center for Responsible Lending, "Non-Negotiable" (January 23, 2014) at 9.

[2] Id.

[3] Id. The difference in APR could be fully explained by any one of these factors and each of these is a neutral reason why finance sources would charge a higher APR on an auto loan.

[4] Id. at 20.

[5] CRL is not a disinterested party. It is closely affiliated with the Self-Help Credit Union. Id. at 31.


AFFORDABLE AUTO FINANCING
UNDER THREAT
DEALERSHIP
TODAY, dealerships work with multiple lenders to find affordable auto loans that save customers money.
CREDIT UNION
Banks, credit unions, and dealers compete
Customer can obtain better monthly payments
Dealers can reduce interest rates to win a customer's business
Flexibility at the dealership helps customers save money!
HOWEVER, the Consumer Financial Protection Bureau (CFPB) is threatening to eliminate dealers' ability to discount interest rates that they offer to their customers.
Ultimately, customers will lose the ability to negotiate a better deal on their financing. The CFPB's proposal would harm consumers by ending dealers' ability to "meet or beat" the interest rates offered by their competitors.
COMPETITION CUT!
DISCOUNTING GONE!
NO REDUCED RATES!
The CFPB should support policies that keep in-dealership auto financing competitive, affordable and readily available.
Produced by
NADA
For more information, please visit: bit.ly/CFPBfacts
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NAFCU

National Association of Federal Credit Unions

The National Association of Federal Credit Unions

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

Statement for the Record

House Financial Services Committee

United States House of Representatives

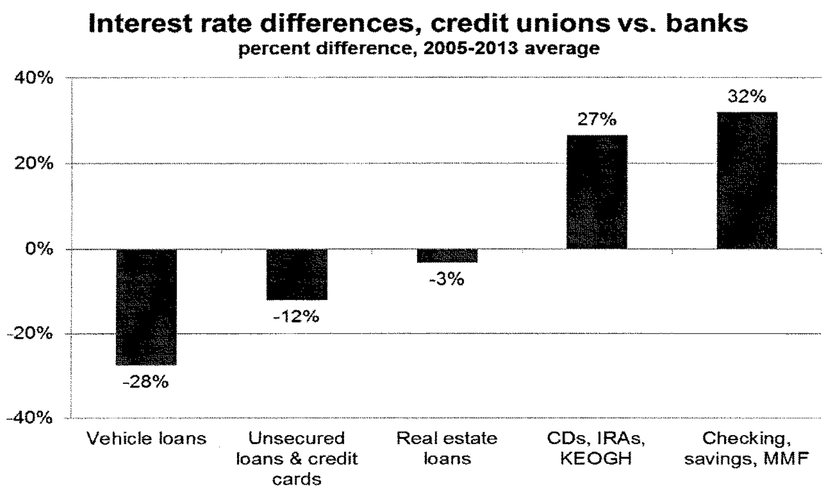
April 8, 2014

Chairman Hensarling, Ranking Member Waters and Members of the Committee, NAFCU, and the entire credit union community, thank you for this opportunity to submit this statement for the record for the Committee's hearing: "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

I. Introduction: Increased Regulatory Burden on Credit Unions

Credit unions have a long track record of helping the economy and making loans when other lenders often have left various markets. This was evidenced during the recent financial crisis when credit unions kept making auto loans, home loans, and small business loans when other lenders cut back. Still, credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital.

Credit unions continue to play a crucial role in the recovery of our nation's economy. Credit unions remain a relatively small part of the marketplace when compared to the banking industry. They are oftentimes a lender of last resort for consumers that have been denied credit via other financial institutions. As detailed in the chart below, on average from 2005-2013, credit unions consistently outperformed banks with lower interest rates on loans and higher returns on savings and deposits.



Today, credit union lending continues to grow at a solid pace, up about 6.8% at the end up 2013 compared to 2009. In short, credit unions didn't cause the financial crisis, helped blunt the crisis by continuing to lend during difficult times, and perhaps most importantly, continue to play a key role in the still fragile economic recovery. While credit unions continue to focus on their members, the increasing complexity of the regulatory environment is taking a toll on the credit

union industry. While NAFCU and its member credit unions take safety and soundness extremely seriously, the regulatory pendulum post crisis has swung too far towards an environment of overregulation that threatens to stifle economic growth. As that National Credit Union Administration (NCUA) and the Consumer Financial Protection Bureau (CFPB) work to prevent the next financial crisis, even the most well intended regulations have the potential to regulate our industry out of business.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this was why NAFCU was the only credit union trade association to oppose the CFPB having rulemaking authority over credit unions. Unfortunately, many of our concerns, about the increased regulatory burdens that credit unions would face under the CFPB, have proven true. While there are credible arguments to be made for the existence of a CFPB, its primary focus should be on regulating the unregulated bad actors, not adding new regulatory burdens to good actors like credit unions that already fall under a functional regulator. As expected, the breadth and pace of CFPB rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense.

The impact of this growing compliance burden is evident as the number of financial institutions continues to decline, dropping by 19.7% (more than 3,200) institutions since 2007. This trend rings true for credit unions as well, and a main reason for the decline is the increasing cost and complexity of complying with the ever-increasing onslaught of regulations. Many smaller institutions simply cannot keep up with the new regulatory tide and have to merge out of business or be taken over.

This growing demand on credit unions is demonstrated by a 2011 NAFCU survey of our membership that found that nearly 97% of respondents were spending more time on regulatory compliance issues than they did in 2009. A 2012 NAFCU survey of our membership found that 94% of respondents had seen their compliance burdens increase since the passage of the *Dodd-Frank Act* in 2010. Furthermore, a March 2013 survey of NAFCU members found that nearly 27% had increased their full-time equivalents (FTEs) for compliance personnel in 2013, as compared to 2012. That same survey found that over 70% of respondents have had non-compliance staff members take on compliance-related duties due to the increasing regulatory burden. This highlights the fact that many non-compliance staff are being forced to take time away from serving members to spend time on compliance issues.

II. NAFCU on Regulatory Burden: Legislative and Regulatory Action Needed

Credit unions didn't cause the financial crisis and shouldn't be caught in the crosshairs of regulations aimed at those entities that did. Unfortunately, that has not been the case thus far. In the wake of the *Dodd-Frank Act*, it became clear that increased regulatory burden at credit unions would forever change the compliance landscape of the entire industry. Finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is the only way for credit unions to thrive and continue to provide their member-owners with basic financial services and the exemplary service they need and deserve. It is also a top goal of NAFCU.

Ongoing discussions with NAFCU member credit unions led to the unveiling of NAFCU's "Five Point Plan for Regulatory Relief" [attachment A] in February 2013, and a call for Congress to enact meaningful legislative reforms that would provide much needed assistance to our nation's credit unions. The "Five Point Plan" covers key areas for credit unions including: Administrative Improvements for the Powers of the NCUA; Capital Reforms for Credit Unions; Structural Improvements for Credit Unions; Operational Improvements for Credit Unions; and, 21st Century Standards for Data Security.

Recognizing that there are a number of outdated regulations and requirements that no longer make sense and need to be modernized or eliminated, NAFCU also compiled and released a document entitled "NAFCU'S Dirty Dozen" [attachment B] in December 2013, that outlines twelve key regulatory issues credit unions face that should be eliminated or amended. The "Dirty Dozen" includes expanding credit union investment authority; updating NCUA's fixed assets rules; improving the process for credit unions seeking changes to their field of membership; increasing the number of transactions allowed to be made per month from savings accounts per the Federal Reserve Regulation D; providing flexibility for credit unions that offer member business loans; updating requirements to disclose account numbers to protect privacy of credit union members; updating advertisement requirements for loans products and share accounts; modernizing NCUA advertising requirements; making improvements to the Central Liquidity Fund; providing flexibility for federal credit unions to operate under state law in certain circumstances; simplifying regulations governing check processing and funds availability; and, eliminating redundant NCUA requirements to provide copies of appraisals upon request.

Our "Five Point Plan" and "Dirty Dozen" outline a number of areas where credit unions need action and we urge the Committee to review these documents. In our statement today, we highlight a number of key issues where regulatory burdens and proposals are posing immediate threats to the ability of credit unions to serve their members and give them the financial products that they want.

III. NCUA's Risk-Based Capital Rule: A Solution in Search of a Problem

On January 23, 2014, the National Credit Union Administration released a proposed "risk-based" capital rule that makes great changes with respect to Prompt Corrective Act (PCA) including replacement of the agency's current risk-based net worth (RBNW) requirements with new requirements for federally insured credit unions over $50 million in assets. While NAFCU is supportive of a risk-based capital regime for credit unions, we do not believe that the NCUA proposal as it currently stands is appropriate. If it were to be implemented as proposed, credit unions could find themselves at a competitive disadvantage to banks.

As proposed, the rule is one-size-fits-all and would serve to stifle growth, innovation and diversification at credit unions. Addressing the NCUA's proposed rule is NAFCU's chief regulatory issue right now, and will quickly become NAFCU's top legislative issue should the NCUA fail to make substantial changes to the rule before it is made final.

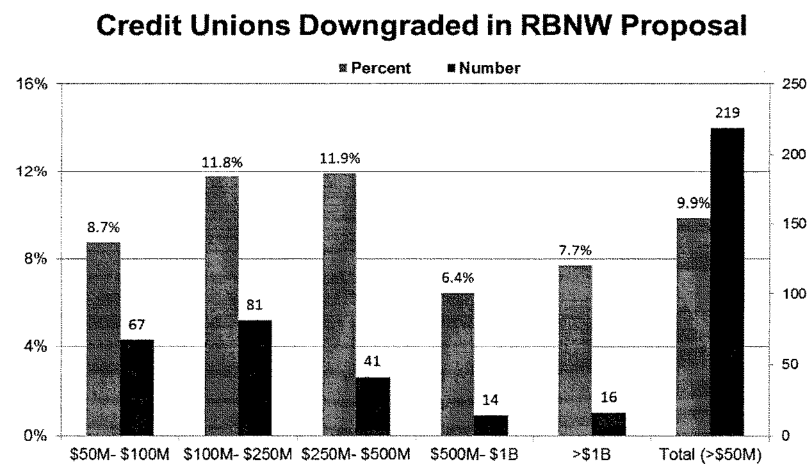
In summary, the proposed rule would:

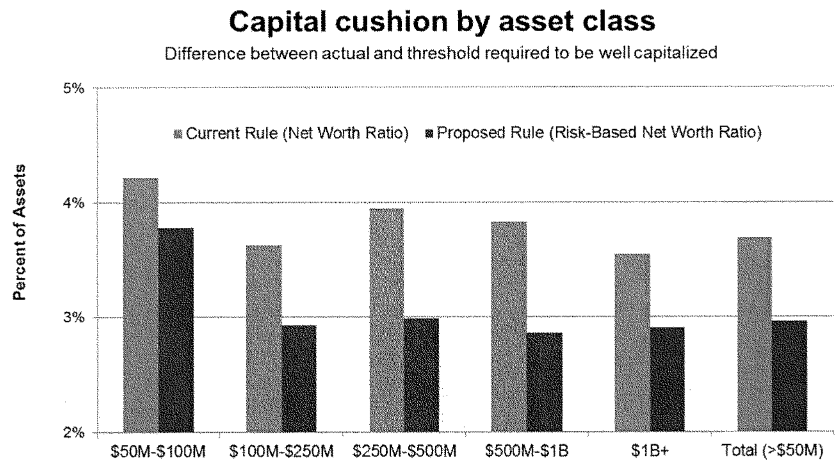
- Amend Part 702 of NCUA regulations regarding PCA to make various revisions, including replacing the agency's current RBNW requirements with new risk-based capital requirements for federally insured "natural person" credit unions.

- Revise the risk-weights for many of NCUA's current asset classifications and require higher minimum levels of capital for federally insured natural person credit unions with concentrations of assets in real estate loans, member business loans (MBLs) or higher levels of delinquent loans.

- Set forth a process where NCUA could require an individual federally insured natural person credit union to hold higher levels of risk-based capital based on supervisory concerns raised through the NCUA examination process.

NAFCU's Economics and Research department prepared the impact analysis graphs found below that outline the impact the proposal would have on credit unions based on their asset size. Our analysis of the proposed rule determined that credit unions with more than $50 million in assets will have to hold $6.7 billion more in additional reserves to achieve the same capital cushion they currently maintain. Because credit unions cannot raise capital from the open market like other financial institutions, this cost will undoubtedly be passed on to the 97 million credit union members across the country. A survey of NAFCU's membership taken last month found that nearly 60% of respondents believe the proposed rule would force their credit union to hold more capital, while nearly 65% believe this proposal would force them to realign their balance sheet. Simply put, if the NCUA implements this rule as proposed, credit unions will have less capital to loan to credit worthy borrowers, whether for a mortgage, auto, or business loan.





The next sections will highlight our particular areas of concern with the proposal and what Congress may be able to do to help.

A. Problematic Risk-Weighting in NCUA's Risk-Based Capital Proposal

The proposed rule revises the risk-weights for many of NCUA's current asset classifications and requires higher minimum levels of capital for credit unions that are perceived as having more risky portfolios. NAFCU and its member credit unions have identified several key areas where risk-weighting in the proposal does not accurately capture the risks associated with the asset in question. In particular, a number of the NCUA proposed risk weights go farther than the FDIC and Basel III requirements for community banks – often without solid justification as to why.

Non-Delinquent First Mortgage Real Estate Loans

The proposed rule uses the non-delinquent first mortgage real estate loans risk-weights to compensate for concentration risk. This is apparent in the proposed risk-weights for non-delinquent first mortgage real estate loans which increase to correspond with the percentage of those assets held by the credit union in their portfolio. Non-delinquent first mortgage real estate loans start at a 50% risk-weight for those loans that represent less than 25% of a credit union's assets, then jumps to 75% for those from 25-35% of assets, and finally goes all the way to 100% for those that comprise more than 35% of the assets of the credit union's portfolio. Of note, the FDIC weights non-delinquent first mortgage real estate loans at 50% regardless of the concentration in the portfolio.

The risk-weights do not take in to consideration any factors that could indicate that the loans are more or less likely to default, including the loan-to-value ratio of loans or credit scores of members who get the loans. These factors should be used to lower the amount of capital required to be held for loans that are safer than others.

One alternative would be for NCUA to eliminate one of the buckets from the proposed rule and adjust the risk-weights to more accurately reflect the risk involved with non-delinquent first mortgage real estate loans. This result would benefit the capital cushion for credit unions at every asset level size compared to the proposed rule, and it would still allow NCUA to control for concentration risk by requiring credit unions to hold more capital if they hold heavy concentrations of real estate loans without straying far from the FDIC risk-weighting.

Investments
The proposed rule uses the investment risk-weights to compensate for interest rate risk. This is apparent in the differences in proposed risk-weights for investments based on the maturity levels of those investments. For investments with a maturity of 0-1 years the proposed risk-weight is 20%. For those with 1-3 year maturities the proposed risk-weight is 50%. It jumps again to 75% for those with 3-5 year maturities and up to 150% for investments with maturities from 5-10 years. If a credit union has an investment with a maturity over 10 years, under the proposed rule, it will have a 200% risk-weight. This is based primarily upon the 300 basis point interest rate shock used by the FDIC. This means NCUA selected the increments for the investment weight scale to match the loss that would take place due to a 300 basis point interest rate shock. For example, if rates increased by 300 basis points, an investment with a 2-year maturity would decline in value by approximately 5%. Since the threshold for a well-capitalized credit union is 10.5%, the weight should be around 50% in order to have an offsetting amount of capital to cover the loss under a 300 basis point shock.

For those investments that credit unions are permitted to make, the FDIC does not incorporate interest rate risk into the investment risk-weights for community banks. Instead, it generally weighs the investments that credit unions can do with a single risk-weight regardless of maturity. FDIC considers steps institutions take to mitigate interest rate risk in its capital requirements. However, NCUA's proposal does not account for any mitigation efforts, such as variable-rate assets or derivatives, which would offset some exposure for credit unions to interest rate risk.

In any final rule, NCUA needs to include a way to factor in the interest rate risk mitigation being done by credit unions. Credit unions already monitor and control for interest rate risk through their own policies and in accordance with NCUA examination and supervision. It is not necessary for a risk-based capital regime to perform this function. If the NCUA does keep interest rate risk built into investment risk-weights, that system should not penalize short or medium term investments.

Member Business Loans
NCUA factored concentration risk into the proposed risk-weighting for MBLs by setting the risk-weights to correspond with the percent of assets in MBLs held by the credit union. This means that every MBL up to 15% of assets for a credit union would be weighted at 100%. Those

MBL assets between 15% and 25% have a risk-weight of 150% and the risk-weights for those MBLs over 25% are 200%.

In the event that NCUA does not reconsider eliminating the concentration risk component of the MBL risk-weights, credit unions chartered historically for business loan purposes should be given a different set of risk-weights that doesn't require them to abandon their core mission for their membership. Those credit unions chartered historically for business loan purposes should be given a risk-weight of 100% for their business loan portfolio. The risks to the portfolios of these special credit unions, including concentration risk, should be managed through the examination and supervision process, not through these capital risk-weights.

Credit unions with proven minimal losses in business lending should be given credit for their diversified portfolios and proven underwriting standards. Risk-weights should also be broken down for types of loans such as agricultural MBLs or commercial real estate MBLs and given appropriate risk-weights based on their actual risk.

Credit Union Service Organizations

The proposal would set the risk-weight at 250% for investments in credit union service organizations (CUSOs) and 100 percent for loans to a CUSO. NAFCU believes the proposed rule does not adequately explain this difference. This suggests that loans to CUSOs are 2.5 times safer than investments in CUSOs.

Investments in CUSOs should be assigned a risk-weight of 100% to align it with loans to a CUSO and more accurately reflect the risk involved with investing in a CUSO. The overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale and providing much needed non-interest income to their credit union owners. Less than 22 basis points of credit union assets are invested in CUSOs and don't represent a systematic risk that could have a significant impact on the National Credit Union Share Insurance Fund (NCUSIF), but this proposed rule could force credit unions to reconsider investments in CUSOs now and in the future.

The chart on the following page is a break-down of risk-weighting at the FDIC (under Basel III) compared to the proposed risk-weighting in the NCUA highlighting areas that will be especially problematic for our nation's credit unions.

Risk Weights: NCUA vs. FDIC

	Category	Sub-Category	NCUA proposal	FDIC weights
Numerator	Liabilities		1	1
	Equity		1	1
	Contra Assets		1	1
	Other Assets	Goodwill	-1	-1
		Identifiable intangible assets	-1	-1
		NCUSIF	-1	
Denominator	Cash		0	0
	Investments*	0-1 Year	0.2	0.2
		1-3 Years	0.5	0.2
		3-5 Years	0.75	0.2
		5-10 Years	1.5	0.2
		>10 Years	2	0.2
		Corporate CU Member Capital	1	
		Corporate Paid-in Capital	2	
	Real Estate Loans	Nondelinquent 1st mort R/E loans (excl. MBLs)		
		<25% of assets	0.5	0.5
		25-35% of Assets	0.75	0.5
		>35% of Assets	1	0.5
		Other R/E and delinquent R/E		
		<10% of Assets	1	1
		10-20% of Assets	1.25	1
		>20% of Assets	1.5	1
	Other Loans	Nondelinquent student loans	1	1
		Nondelinquent other loans	0.75	1
		Delinquent other loans	1.5	1.5
		SBA	-0.8	-0.8
		Member business loans		
		<15% of Assets	1	1
		15-25% of Assets	1.5	1
		>25% of Assets	2	1
	Other Assets	Goodwill	-1	-1
		Identifiable intangible assets	-1	-1
		NCUSIF	-1	
		Inv't in CUSO	2.5	
		Mort servicing rights	2.5	2.5
		All other assets	1	1
	Off Bal Sheet	Loans with recourse	0.75	
		Unfunded commitments bus loans (75% conversion)	1	1
		Unfunded commitments non-bus loans (10% conversion)	0.75	1
	Capitalization thresholds			
		Well Capitalized	10.5%	10.0%
		Adequately Capitalized	8.0%	8.0%

* U.S. Treasuries and other direct and unconditional claims on the U.S. government are weighted at 0 by both NCUA and FDIC. Most other credit union investments are weighted from .2 to 2 according to their maturity. They would generally be rated at a constant 0.2 under the FDIC rule.

B. Additional Key Concerns with the NCUA's Risk-Based Capital Proposal

In addition to problematic risk-weighting and inadequate details with respect to how the weighting was derived for many of the asset classes, NAFCU has several other key concerns with the NCUA's risk based capital proposal.

Individual Minimum Capital Requirement
The proposed rule provides NCUA the ability to require a higher minimum risk-based capital ratio for an individual credit union in any case where NCUA determines that the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. This means that NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is or may become inadequate in light of the credit union's circumstances regardless of the actual risk-based capital ratio of the credit union.

In other words, NCUA can increase a credit union's individual risk-based capital requirement by subjective action through the examination process or "supervisory assessment" based on the determination that the credit union needs additional capital based on the credit union's balance sheet risk. A survey of NAFCU's membership taken last month found that over 65% of respondents have serious concerns over this portion of the rule.

NAFCU believes there are serious concerns about the legal authority of NCUA to enact this portion of the rule. Outside of the ability of the NCUA Board to institute individual minimum capital requirements in the first place, there are also questions surrounding whether that authority can be delegated by the Board to anyone, such as an examiner.

In addition to potential legal issues, this portion of the proposal seems to undermine the stated purpose of the rule. On the one hand, credit unions are led to believe that the proposal is designed to factor in a number of different risks. On the other hand, if the risk-based capital ratios laid out in the proposal don't result in the numbers the regulator wants to see, the NCUA can change the rules for an individual credit union. This makes it nearly impossible for credit unions to make a sound business decision about the makeup of their portfolio and will lead to even more uncertainty for credit unions and their members.

Implementation Time-Frame
The proposed rule has an implementation time period of 18 months after the passage of a final rule and its publication in the *Federal Register*. NAFCU believes, given the sweeping changes in the proposal, that the time frame is entirely too short. It will take time for credit unions to adjust their balance sheets related to this new regulation. That doesn't include the changes that need to be made to internal systems and operations well in advance of the effective date.

NAFCU believes any implementation period should be no less than three years after passage of any final rule. Credit unions will need at least that long to make safe and sound decisions about potential fundamental changes to their core business decisions including investments and product offerings.

Reputational Risk
It is also worth noting that upon release of the risk-based capital proposal, the NCUA publicly posted an online calculator that allows credit unions to view what their risk-based capital ratio under the proposed rule would be. While NAFCU supported the intent to make it easy for credit unions to gauge the rule's impact on their balance sheets, the existence of the calculator in a public forum has the potential to raise reputation risk issues. NCUA has now indicated that the calculator will be removed at the end of the comment period. Due to the ease of information dissemination with current technology, how data is presented, and how it impacts our members, is a key concern for NAFCU.

C. NCUA's Risk-Based Capital Proposal: How Congress Can Help

At this stage in the rule-making process, rigorous Congressional oversight is critical in ensuring the NCUA's risk-based capital proposal does not inhibit the ability of consumers to access the basic financial services and competitive rates credit unions often provide. Today's hearing is an appropriate setting for the NCUA to provide additional information about the proposed rule, including the metrics used to determine what asset classifications needed revision, and a justification for the revised weighting associated with each individual asset class. As outlined above, NAFCU believes that there should be strong scrutiny applied to the requirement of higher minimum levels of capital for credit unions with concentrations of assets in real estate loans, member business loans, or higher levels of delinquent loans in an attempt to factor in concentration risk. These higher requirements could have a chilling effect on credit union lending going forward, as credit unions would have to hold more capital just to make loans, which, in turn, could end up harming the American consumer and the still fragile American economy.

As the credit union community begins to comment to NCUA on this rule, NAFCU is hopeful that the NCUA Board will realize the devastating effect that this proposal will have on the credit union industry, the American consumer, and our nation's small businesses. While we are supportive of the idea of a risk-based capital regime for credit unions, the current NCUA proposal got it wrong. We hope that they will ultimately withdraw or make major modifications to their proposal before it goes into effect. As you may know, the open comment period is scheduled to close on May 28, 2014.

Should NCUA's proposal go forward with little or no changes, the new rule would precipitate the need for Congressional action on proposals to bring about capital changes for credit unions such as H.R. 719, the *Capital Access for Small Businesses and Jobs Act*, which would allow credit unions to have access to supplemental capital sources. In addition this would prompt the need for statutory changes necessary to design a true risk-based capital system for credit unions. Lastly, a final rule mirroring the proposal in terms of an individual credit union's risk-based capital requirements being changed through the exam process only reinforces the need for action on H.R. 1553, the *Financial Institutions Examination Fairness and Reform Act*. NAFCU looks forward to continuing to work with Congress on this timely issue.

IV. Other Regulatory Issues at the National Credit Union Administration

There are a number of other issues which impact credit unions and that NAFCU has weighed in with the NCUA about. We stand ready to work with the agency to address our concerns, but we also raise them today so that Congress may provide oversight in these areas and stand ready to act if needed.

Budget Transparency
As the agency charged by Congress to regulate, charter, and supervise federal credit unions, NCUA oversees and manages the National Credit Union Share Insurance Fund (NCUSIF), the Temporary Corporate Credit Union Stabilization Fund (TCCUSIF), the Central Liquidity Fund (CLF), and its annual operating budget. These funds are comprised of monies paid by credit unions. NCUA is charged with protecting these funds and using its operating budget to advance the safety and soundness of credit unions.

Because these funds are fully supported by credit union assets, credit unions are entitled to know how each fund is being managed. Currently, NCUA publicly releases general financial statements and aggregated balance sheets for each fund. However, the agency does not provide non-aggregated breakdowns of the components that go into the expenditures from the funds. Although NCUA releases a plethora of public information on the general financial condition of the funds, NAFCU urges the agency to fully disclose the amounts disbursed and allocated for each fund.

Field of Membership Issues
NAFCU believes reasonable improvements to current field-of-membership restrictions include: (1) streamlining the process for converting from one charter type to another; (2) removing or greatly increasing the current population limits for serving members in a metropolitan area (1 million) and contiguous political jurisdictions (500,000); and, (3) making it easier for all credit unions to add "underserved" areas within their field of membership.

Member Business Lending (MBL) Flexibility
Additional flexibility is needed for credit unions that offer member business loans. In particular, NAFCU urges Congressional action on the bipartisan *Credit Union Small Business Jobs Creation Act,* H.R. 688, which would raise the arbitrary and outdated MBL cap on credit unions. We also urge Congressional action on the *Credit Union Residential Loan Parity Act*, H.R. 4226, which would exclude loans made non-owner occupied 1- to 4-family dwelling from the definition of a member business loan. In the meantime, NAFCU has suggested improvements to the NCUA's regulations regarding member business lending including: (1) securing credit union-friendly changes to the waiver process; (2) increasing the general minimum loan-to-value ratio from 80% to 85%; and, (3) securing removal of the 5 year relationship requirement.

NCUA Advertising
In an attempt to keep up with ever changing technology, NAFCU believes the NCUA should update credit union advertising requirements to clarify that the official NCUA share insurance logo is not required to be displayed on (1) mobile applications, (2) social media, and (3) virtual tellers.

V. Ongoing Examination Issues at the NCUA

Credit unions now face more examiner scrutiny than ever, as the examination cycles for credit unions have gone from 18 months to 12 months since the onset of the financial crisis even though credit union financial conditions continue to improve. Additional exams mean additional staff time and resources to prepare and respond to examiner needs.

NAFCU supports effective exams that are focused on safety and soundness and flow out of clear regulatory directives. However, the examination process, by its very nature, can be inconsistent. Regulatory agencies in Washington try to interpret the will of Congress, examiners in the field try to interpret the will of their agency, and financial institutions often become caught in the middle as they try to interpret all three as they run their institution. Unfortunately, the messages are not always consistent.

Exam Modernization

As part of its Regulatory Modernization Initiative, NCUA recently issued its Letter to Credit Unions (Letter No. 13-CU-09). It streamlined the examination report and clarifies for credit unions the difference between a Document of Resolution (DOR) and an Examiner's Findings Report. Full implementation of these new documents began with exams that started on or after January 1, 2014.

NAFCU has concerns about the continued use of Documents of Resolution (DOR) when they are not necessary or are used in place of open and honest conversations about examiner concerns. Examiner Findings Reports should be used in place of DORs for less urgent issues. That would allow management may use its own discretion to determine the timeframe and approach for correcting those less urgent problems.

Consistency

One of the most troublesome complaints we hear is that NCUA examinations continue to apply regulations inconsistently. While we fully recognize that examiners must have a certain degree of discretion, as we have previously communicated to the agency, inconsistent examinations and application of regulations create unnecessary confusion and are costly.

Additionally, regulators should ensure that their regulations are consistently applied from one examiner to another. Inconsistent application of laws and regulations among examiners increases uncertainty. This increased uncertainty adds another unnecessary layer of difficulty for credit unions to maintain the highest levels of compliance.

More importantly, it is also unclear how an examiner will evaluate compliance. In addition to actual regulations, NCUA also routinely provides "guidance" in any one of a number of different forms. Some examiners treat the guidance as just that; a tool to be used for credit unions to comply with regulations or implement best practices. Some examiners, however, treat the "guidance" as if it were part of the regulation itself, and consider failure to comply with the guidance as something roughly equal to failing to comply with the regulation. More should be

done to ensure that all examiners treat both regulations and guidance consistently and for the purpose each was issued.

Unfortunately, if examinations are not conducted consistently, compliance with the ever-growing number of regulations will be ever more difficult. As a significant percent of examiners are new and with a large number retiring, NCUA will no doubt be continuing to hire new examiners. Thus, we believe that this is a critical juncture, as well as a great opportunity, for the agency to appropriately train and educate examiners so that examinations are conducted consistently. With this goal in mind, NCUA should take any and all measures it deems appropriate to achieve this goal.

Examination Notification

NAFCU appreciates NCUA's efforts on several fronts to improve transparency and clarity for examiners and credit unions. One suggestion that NAFCU has made that would help both credit unions as well as examiners, is to extend the notification to a credit union of upcoming examinations and supervisory contacts where applicable.

NAFCU shares NCUA's goal of having a strong and safe credit union system. With that in mind, we are not advocating for elimination of surprise exams when the Examiner-in-Charge sees fit for institutions with weak internal controls. We are asking that like the FDIC, the NCUA also require examiners to contact credit unions two months prior to routine exams in order to minimize disruptions to credit unions and to help facilitate efficient examinations.

Examination Appeal Process

NAFCU understands that some of our concerns cannot be addressed by regulators. Generally, NCUA and its examiners do a satisfactory job, but every inconsistency that forces credit unions to divert more resources to compliance reduces their ability to better serve their members. This ultimately translates to lower interest rates on savings, higher interest rates on loans, and in some cases, the inability to extend credit to a member that would receive credit otherwise.

NAFCU urges reforms to establish an appeals process that should provide an opportunity to identify inconsistencies and serve as a quality assurance check. The existing appeal process does not promote either. Under the existing process, if an examiner makes a determination to take action against the credit union, the credit union must first address the issues with the examiner. The second step is to contact the supervisory examiner, who evaluates the facts and reviews the analysis. If the issue is still not resolved, the credit union may send a letter to the regional director. After the previous steps have been taken, a credit union may then appeal to the NCUA Board for review of the decisions below.

The appeal process has a number of inherent flaws, not the least of which is the exclusion (in most instances) of a review by an independent third party at any level of the process. Under these circumstances it is almost impossible to avoid conflicts of interest and approach each situation objectively.

Again, NAFCU believes that the bipartisan *Financial Institutions Examination Fairness and Reform Act* (H.R. 1553) is a positive first step in improving the examination process and

supports the legislation. Introducing an independent third party to the appeal process will ensure that consistent standards are applied and will help bring more certainty to the examination process.

VI. Other Business Pending at the National Credit Union Administration

In addition to the issues outlined above, there are several key issues currently being reviewed by the agency that NAFCU is following for their potential impact on credit unions.

Examination Sites

In addition to the exam concerns detailed earlier, it's also worth noting that in December 2013, the NCUA proposed rulemaking regarding requirements for contacts with federal credit unions. While NAFCU agrees that the NCUA needs to address important issues such as the need for responsive communication and employee safety, the proposal goes too far in requiring credit unions to obtain and maintain commercial office space during exams. NAFCU believes this is an issue of fairness, and that the NCUA should move examination sites to public locations if office space at the credit union is not available. A final rule on this issue is expected in the coming months amid continued concerns that it could put some smaller credit unions out of business.

Stress Testing

In October 2013, NCUA released a proposed rule that would require annual stress testing for credit unions with more than $10 billion in assets. In addition, the proposed rule would require such credit unions to submit, on an annual basis, capital plans with certain mandatory elements and analyses. At a minimum, a credit union subject to the proposed rule would be required to conduct a sensitivity analysis to evaluate the effect on capital of changes in variables, parameters and inputs used by the credit union in its capital plans. It would also have to test the impact of interest rate shocks of at least +/- 300 basis points on the net economic value of the credit union, using final maturities of non-maturity shares not exceeding two years. These credit unions must also analyze the impact of credit risk to capital under unfavorable conditions, both separately and in combination with unfavorable interest scenarios. The proposal aims to advance regulatory parity with the banking regulators. However, the parameters NCUA has prescribed have imposed more stringent requirements on credit unions than those imposed on banks. As such, NAFCU has suggested changes to the rule, especially since credit unions already do their own stress testing.

NAFCU is concerned that additional NCUA stress testing and oversight would only create greater cost and burden to the entire credit union industry.

VII. Regulatory Issues at the Consumer Financial Protection Bureau (CFPB)

In addition to regulations from the NCUA, all credit unions are subject to the rulemaking of the CFPB. The tidal wave of new regulations coming from the Bureau, even if they are well-intentioned, has proven to be overwhelming to credit unions, as they are often forced to comply with the exact same rules as our nation's mega banks, and their armies of lawyers. The CFPB

has done a good job in soliciting feedback and input from credit unions during their rulemaking processes. However, many of their rules have fallen short of addressing the concerns expressed by credit unions during the process. We hope to work with the Bureau to address these concerns going forward. Still, there are a number of areas where CFPB rules have had dramatic impact on credit unions and their ability to serve their 97 million members.

A. Remittances

The *Dodd-Frank Act* added new requirements involving remittance transfers under the *Electronic Fund Transfer Act* (EFTA) and directed the CFPB to issue final rules amending Regulation E to reflect these additions. Under this mandate, the Bureau, released a series of final rules concerning remittances, all of which became effective on October 28, 2013.

In February 2012, the CFPB issued its first set of final rules on remittances. These rules required, among other things, remittance service providers, including credit unions, to provide a pre-payment disclosure to a sender containing detailed information about the transfer requested by the sender, and a written receipt on completion of the payment. Following the release of the February 2012, final rule, the CFPB issued on August 20, 2012, a supplemental final that provided a safe harbor for determining whether a credit union is subject to the remittance transfer regulations. Specifically, a credit union that conducts 100 or fewer remittances in the previous and current calendar years would not be subject to the rules.

In May 2013, the Bureau modified the final rules previously issued in 2012, to address substantive issues on international remittance transfers. This final rule eliminated the requirement to disclose certain third-party fees and taxes not imposed by the remittance transfer provider and established new disclaimers related to the fees and taxes for which the servicer was no longer required to disclose. Under the rule, providers may choose, however, to provide an estimate of the fees and taxes they no longer must disclose. In addition, the rule created two new exceptions to the definition of error: situations in which the amount disclosed differs from the amount received due to imposition of certain taxes and fees, and situations in which the sender provided the provider with incorrect or incomplete information.

NAFCU opposed the transaction size-based threshold for the final rule's safe harbor. The CFPB relied on an institution size-based threshold, rather than a transaction size-based threshold, in its recently released mortgage rules, and NAFCU urged the Bureau to adopt a similar approach for differentiating between remittance transfer providers. Additionally, NAFCU raised concerns with the final rule's requirement of immediate compliance if an entity exceeds the safe harbor's 100 transaction threshold. It encouraged the CFPB to allow entities who exceed the safe harbor threshold a realistic period in which to meet the standards of the final rule.

NAFCU continues to raise concerns that the regulatory burden imposed by the final rule leads to a significant reduction in consumers' access to remittance transfer services. NAFCU has heard from a number of its members that, because of the final rule's enormous compliance burden, they have been forced to discontinue, or will be forced to discontinue, their remittance programs. A 2013, NAFCU survey of our members found that over one-quarter of those that offered remittance services before the rule have now stopped offering that service to members and even

more are considering dropping. Those that continue to offer remittances have been forced to significantly increase their members' fees. NAFCU encourages the CFPB to expand the threshold for the safe harbor from the definition of "remittance transfer provider" in order to ensure that a meaningful safe harbor is established.

B. HMDA Changes Going Beyond the *Dodd-Frank Act*

The *Dodd-Frank Act* transferred *Home Mortgage Disclosure Act* (HMDA) rulemaking authority to the CFPB and directed the Bureau to expand the HMDA dataset to include additional loan information that would help in spotting troublesome trends. Specifically, Dodd-Frank requires the Bureau to update HMDA regulations by having lenders report the length of the loan, total points and fees, the length of any teaser or introductory interest rates, and the applicant or borrower's age and credit score. However, the Bureau is also contemplating adding additional items of information to the HMDA dataset. NAFCU urges the CFPB to limit the changes to the HMDA dataset to those mandated by Dodd-Frank.

HMDA was originally intended to ensure mortgage originators did not "redline" to avoid lending in certain geographical areas. The HMDA dataset should be used to collect and provide reasonable data for a specific reason. The Bureau contends that it is going beyond Dodd-Frank's mandated changes to get "new information that could alert regulators to potential problems in the marketplace" and "give regulators a better view of developments in all segments of the housing market." These open-ended statements could be applied to virtually any type of data collection, and do not further the original intent of HMDA. NAFCU urges the CFPB to amend the dataset to advance the original purpose of HMDA, rather than using it as a vehicle to "police" its recent Qualified Mortgage rules.

The various mortgage-related regulations promulgated by the CFPB have exponentially increased credit unions' regulatory burden and compliance costs. Any additions to the HMDA dataset will create even more operational expenses for credit unions. Credit unions that collect and report HMDA data through an automated system will have to work with their staffs and vendors to update their processes and software. Those without automated systems will experience particularly significant implementation costs. The CFPB should eliminate unnecessary regulatory burden and compliance costs by limiting the changes to the HMDA dataset to those mandated by Dodd-Frank.

C. TILA/RESPA

Dodd-Frank directed the CFPB to combine the mortgage disclosures under the *Truth in Lending Act* and *Real Estate Settlement Procedures Act*. Under this mandate, the Bureau, in November 2013, released the integrated disclosures rule. This 1900-page rule requires a complete overhaul of the systems, disclosures, and processes currently in place for a consumer to obtain a mortgage. For example, the rule mandates the use of two disclosures: the three-page Loan Estimate (which replaces the Good Faith Estimate and initial Truth in Lending Disclosure); and the five-page Closing Disclosure (which replaces the HUD-1 and final Truth in Lending disclosure). There are also a number of stringent timing requirements and other substantive changes lenders must follow. The rule is effective August 2015, but lenders are still feeling pressure to be compliant

on time. The sheer magnitude of this rule, read in conjunction with the totality of the other mortgage rules, has created a very burdensome regulatory environment and many credit unions are finding it difficult to continue lending. Credit unions must comply with the current disclosure requirements, which are extensive, and they must prepare their compliance solutions for the upcoming ones effective in August 2015, further exacerbating costs.

D. Qualified Mortgages

NAFCU continues to have serious concerns about the "Qualified Mortgage" (QM) standard. In short, given the unique member-relationship credit unions have, many make good loans that work for their members that don't fit into all of the parameters of the QM box and fall into the "non-qualified mortgage" category. NAFCU would support the changes below to the QM standard to make it more consistent with the quality loans credit unions are already making. Further, credit unions should have the freedom to decide whether to make loans within or outside of the standard without pressure from regulators.

Points and Fees
NAFCU strongly supports bipartisan legislation in both the Senate and House to alter the definition of "points and fees" under the "ability-to-repay" rule. NAFCU has taken advantage of every opportunity available to educate and discuss with the CFPB on aspects of the ability-to-repay rule that are likely to be problematic for credit unions and their members. While credit unions understand the intention of the rule and importance of hindering unscrupulous mortgage lenders from entering the marketplace, it is time for Congress to address unfair and unnecessarily restrictive aspects of this CFPB rule.

NAFCU supports exempting from the QM cap on points and fees: (1) affiliated title charges, (2) double counting of loan officer compensation, (3) escrow charges for taxes and insurance, (4) lender-paid compensation to a correspondent bank, credit union or mortgage brokerage firm, and (5) loan level price adjustments which is an upfront fee that the Enterprises charge to offset loan-specific risk factors such as a borrower's credit score and the loan-to-value ratio.

Making important exclusions from the cap on points and fees will go a long way toward ensuring many affiliated loans, particularly those made to low- and moderate-income borrowers, attain QM status and therefore are still made in the future.

Loans Held in Portfolio
NAFCU supports exempting mortgage loans held in portfolio from the QM definition as the lender, via its balance sheet, already assumes risk associated with the borrower's ability-to-repay.

40-year Loan Product
Credit unions offer the 40 year product their members often demand. To ensure that consumers can access a variety of mortgage products, NAFCU supports mortgages of duration of 40 years or less being considered a QM.

Debt-to-Income Ratio
NAFCU supports Congress directing the CFPB to revise aspects of the 'ability-to-repay' rule that dictates a consumer have a total debt-to-income (DTI) ratio that is less than or equal to 43 percent in order for that loan to be considered a QM. This arbitrary threshold will prevent otherwise healthy borrowers from obtaining mortgage loans and will have a particularly serious impact in rural and underserved areas where consumers have a limited number of options. The CFPB should either remove or increase the DTI requirement on QMs.

E. Prepaid Card Issues

The CFPB is likely to issue a proposed rule on prepaid cards in June. That proposed rule will explore bringing prepaid cards under Regulation E. Credit unions have a number of unique issues that need to be taken into consideration when dealing with prepaid cards.

NAFCU is concerned that the CFPB may treat prepaid card products in the same fashion that checking and savings accounts are currently treated. On the surface, there are obvious similarities between prepaid cards and debit cards; however, these products are functionally quite different. The law, regulations, back room operations and internal processes and procedures for offering checking accounts and prepaid cards are not identical, or even similar. They should not be pigeon-holed into a regulatory and operational structure designed for checking and savings account products.

Linked Savings Accounts
NAFCU cautions against any regulatory efforts to require institutions to offer any sort of linked savings account with a general purpose reloadable gift card. Such a measure might have the unintended consequence of driving providers from the market. Smaller institutions will particularly have difficulties implementing such requirements. While such a feature may be suitable for some consumers, it is worth noting that many consumers use prepaid cards because they do not want, or feel they do not need, a checking or savings account. Institutions should be free to establish these sorts of linked accounts according to their business judgment.

Share Insurance Fund
Credit union deposits are insured by the National Credit Union Share Insurance Fund (NCUSIF). There needs to be clear interpretation about whether any regulation for general purpose reloadable prepaid cards would require the underlying funds to be covered by share insurance, which potentially would require changes to the *Federal Credit Union Act*.

Any rules or laws that deal with prepaid cards also need to ensure that any potential rules on deposit or share insurance for prepaid cards are consistent with NCUA's rules and regulations, especially with regard to share insurance and pooled accounts, so credit unions can continue to provide prepaid cards.

F. Overdraft Protection

As a preliminary matter, NAFCU and its members believe that overdraft protection is a useful service that provides value to consumers. Overdraft programs have evolved to fit consumers'

wants and needs. For example, defense credit unions tailor their programs in a number of different ways in order to better serve the needs of their unique membership. For some time, credit unions have not used a one size fits all approach to overdraft protection.

NAFCU strongly supports, as part of any overdraft protection program, strong disclosures to make sure consumers are informed of the details of the program. While overdraft programs vary from credit union to credit union, there are some common characteristics that are true of most credit union overdraft programs. Many credit unions treat overdraft protection in a manner similar to loan underwriting; allowing members to qualify for overdraft protection only after checking the credit history and past performance on checking accounts. Credit unions also generally monitor their members' activity to ensure that the service is not being abused. Mark Colley, the President and CEO of Tulsa Postal & Community Federal Credit Union testified on behalf of NAFCU in 2009 on legislation regarding overdraft protection. Mr. Colley's credit union is located near several casinos and he testified that his credit union shuts off its courtesy pay service if it is discovered that the service is being abused at casinos. Many credit unions similarly track overdraft fees, work with members who use the service excessively and provide education on ways to better manage their finances.

While NAFCU understands that the CFPB plans to examine this service further, we are hopeful that the Bureau will take time to carefully consider the myriad of different ways that institutions provide overdraft protection. The CFPB should ensure that new regulations do not make it more difficult for credit unions to continue offering responsible, cost-effective overdraft programs that serve their members.

Credit unions often provide alternatives to traditional overdraft protection services. The most common alternative is linking the checking account to the consumer's savings account. Additionally, the majority of credit unions offer a line of credit that automatically transfers funds to the checking account in the event of an overdraft. Many credit unions encourage members who wish to have overdraft protection to link the checking account to their savings account in order to minimize overdraft fees.

There is one significant issue with linked savings accounts. Under the Federal Reserve's Regulation D, a consumer may not make more than six transactions per month from his or her savings account, with some narrow exceptions. The CFPB should work with the Federal Reserve to clarify that a transfer from a savings account to cover overdrafts from accounts at the same depository institution are not covered Regulation D transactions that count against the six transaction limit. Without addressing the limits imposed on savings accounts by Regulation D, any attempt to encourage more consumers to link checking accounts will prove inadequate.

G. Consumer Complaint Database

In 2013, the CFPB created the "Consumer Complaint Database" to publicly disclose credit card complaints that the Bureau received from consumers. The database has been expanded to include complaints that the CFPB receives on most financial products, such as mortgages, bank accounts and services, private student loans, other consumer loans, credit reporting, money transfers, payday loans, and debt collection.

While NAFCU acknowledges the importance of complaint resolution, it is concerned with the Bureau's complaint database and its disclosure process. The CFPB does not verify the accuracy of member complaints before making them publicly available in the database. Although CFPB acknowledges the fact that this data is unverified in a disclosure on the database's website, the disclosure statement is weak and does not effectively emphasize that the data is unverified. As a result, baseless complaints are often publicly disclosed on the CFPB's website. Such disclosure raises safety and soundness concerns and unduly places financial institutions' reputation at risk. NAFCU is concerned by this possible increased reputation risk to credit unions, and continues to urge the CFPB to take all steps possible to ensure the complaint data it releases to the public has been verified.

H. Legal Opinion Letters

In attempting to understand ambiguous sections of CFPB rules, NAFCU and many of its members have reached out to the CFPB to obtain legal opinion letters as to the agencies interpretation if it's regulations. While legal opinion letters don't carry the weight of law, they do provide guidance on ambiguous section of regulations. Many other financial agencies such as NCUA, FTC, FDIC and others issue legal opinion letters so as to help institutions and other agencies understand otherwise ambiguously written rules. The CFPB has refused to do so. What they have done is set up a help line where financial institutions can call for guidance from the agency. While this is helpful, there are reports of conflicting guidance being given depending on who answers the phone. This is not just unhelpful, but confusing when NCUA examines credit unions for compliance with CFPB regulations.

VIII. Regulatory Coordination is More Important Than Ever

With numerous new rulemakings coming from regulators, coordination between the agencies is more important than ever. Having to answer to multiple regulators can create conflicts for credit unions (as outlined in the discussion about legal opinion letters above). Congress should use its oversight authority to make sure that regulators are coordinating their efforts and not duplicating burdens on credit unions by working independently on changes to regulations that impact the same areas of service. There are a number of areas where opportunities for coordination exist and can be beneficial.

Financial Stability Oversight Council (FSOC)
NAFCU has been on the forefront encouraging the FSOC regulators to fulfill their Dodd-Frank mandated duty to facilitate rule coordination. This duty includes facilitating information sharing and coordination among the member agencies of domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions. Through this role, the FSOC is effectively charged with ameliorating weaknesses within the regulatory structure and promoting a safer and more stable system. It is extremely important to credit unions for our industry's copious regulators to coordinate with each other to help mitigate regulatory burden. We urge Congress to exercise oversight in this regard and consider putting into statute parameters that would encourage the FSOC to fulfill this duty in a thorough and timely manner.

Data Security
Outside of advocating for federal legislation with regard to the safekeeping of information and breach notification requirements for our nation's retailers, NAFCU has also urged regulatory coordination for credit unions already in compliance with the stringent standards in the *Gramm-Leach-Bliley Act*. In the wake of the massive Target data breach in December 2013 the Federal Trade Commission began exploring a range of regulatory options to assist consumers, businesses, and financial institutions. Moving forward, it is imperative that the NCUA ensure that credit unions are protected from any unnecessary regulatory burden and continue to allow them to provide quality services to their members.

IX. Conclusion: The Need for Regulatory Relief and Congressional Oversight

The growing regulatory burden on credit unions is the top challenge facing the industry today. The number of credit unions continues to decline, as the compliance requirements in a post Dodd-Frank environment have grown to a tipping point where it is hard for many smaller institutions to survive. Credit unions want to continue to aid in the economic recovery, but are being stymied by overregulation. Congress must continue to provide vigorous oversight to the regulators of credit unions, and encourage them to look for ways to provide relief for credit unions through commonsense and coordinated regulation and eliminating or amending outdated requirements such as those outlined in NAFCU's "Dirty Dozen" and in this statement. Congress should also enact the regulatory relief measures outlined in NAFCU's "Five Point Plan for Credit Union Regulatory Relief" and stand ready to step in and take action on the issues outlined in this statement should regulators fail to take the appropriate steps.

We thank you for the opportunity to share our thoughts with you today.

Attachment A:

NAFCU's Five-Point Plan for Credit Union Regulatory Relief

Learn How NAFCU's Five-Point Plan Will Bring Regulatory Relief to Credit Unions

In February 2013, NAFCU was the first trade association to call on this Congress to provide comprehensive broad-based regulatory relief for credit unions. As part of this effort, NAFCU sent Congress a five-point plan for regulatory relief that will significantly enhance credit unions' ability to create jobs, help the middle class, and boost our nation's struggling economy. The five-point plan is built on a solid framework of recommendations that provide regulatory relief through the following:

1. Administrative Improvements for the Powers of the NCUA

- Allow a federal credit union to petition NCUA for a waiver of a federal rule in favor of a state rule.
- Provide NCUA the authority to delay implementation of CFPB rules that affect credit unions and to tailor those rules for credit unions' unique structure.
- Require a cost/benefit analysis of all rules that includes a three-year look back and reevaluation of rules that cost 20 percent or more than their original cost estimate.
- Enact new examination fairness provisions to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation.
- Improve the Central Liquidity Facility by removing the subscription requirement for membership and permanently removing the borrowing cap.

2. Capital Reforms for Credit Unions

- Direct NCUA and industry representatives to conduct a study on prompt corrective action and recommend changes.
- Modernize capital standards by directing the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks and allows the NCUA Board to authorize supplemental capital.
- Establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

3. Structural Improvements for Credit Unions

- Direct NCUA, with industry input, to conduct a study of outdated corporate governance provisions in the Federal Credit Union Act and make recommended changes to Congress.
- Improve the process for expanding a federal credit union's field of membership by allowing voluntary mergers among multiple common bond credit unions, easing the community charter conversion process and making it easier to include those designated as "underserved" within a credit union's field of membership.

4. Operational Improvements for Credit Unions

- Raise the arbitrary cap on member business loans to 27.5% or raise the exemption on MBL loans from $50,000 to $250,000, adjusted for inflation, and exempt loans made to non-profit religious organizations, businesses with fewer than 20 employees and businesses in "underserved areas."
- Remove requirements to mail redundant and unnecessary privacy notices on an annual basis, if the policy has not changed and new sharing has not begun since the last distribution of the notice.
- Allow credit unions greater authority and flexibility in how they invest.
- Provide NCUA the authority to establish longer maturities for certain credit union loans and greater flexibility in responding to market conditions.
- Provide federal share insurance coverage for Interest on Lawyers Trust Accounts (IOLTAs).

5. 21st Century Data Security Standards

- Establish national standards for safekeeping of all financial information.
- Establish enforcement standards for data security that prohibit merchants from retaining financial data, and require merchants to disclose their data security policies to customers.
- Hold merchants accountable for the costs of a data breach, especially when it was due to their own negligence; shift the burden of proof in data breach cases to the party that incurred a breach and require timely disclosures in the event of a breach.

For more information, visit **www.nafcu.org/regrelief.**

NAFCU

National Association of Federal Credit Unions | www.nafcu.org

Attachment B:

NAFCU's "Dirty Dozen"

12 Regulations to Eliminate or Amend

NAFCU's "Dirty Dozen" - Twelve Regulations to Eliminate or Amend

1. **Expand credit union investment authority** to include permissible investments in derivatives, securitization and mortgage servicing rights. NAFCU strongly pushed for the expansion of credit unions' investment authority to include the ability to engage in limited derivatives activities. NAFCU will continue to seek this authority for qualified credit unions. In addition, NAFCU will push for the authority to securitize loans and expanded ability to invest in mortgage servicing rights.

2. **Seek updates and modernization of the NCUA's fixed assets rule.** In particular, the NCUA should: (1) increase the current 5 percent aggregate limit; (2) re-define what constitutes "fixed assets"; and, (3) improve the process of obtaining a waiver.

3. **Improve the process for credit unions seeking changes to their field of membership.** Improvements should include: (1) enabling credit unions to strengthen their associational membership charter; (2) streamlining the process for converting from one charter type to another; (3) remove or greatly increase the current population limits for serving members in a metropolitan area (1 million) and contiguous political jurisdictions (500,000); and, (4) making it easier for all credit unions to add "underserved" areas within their field of membership.

4. **Increase the number of transfers allowed to be made per month from savings accounts.** The restriction on "convenience transfers" under Regulation D presents an ongoing concern for NAFCU and its members. Members are often unable to understand and remember the arbitrary limits on the number and types of transfers the regulations permit them to make from their savings account. Members expect to have the ability to transfer their funds with ease to and from particular accounts, and the regulation's six-transfer limitation from savings accounts creates an undue burden for both members and credit unions. This six-transfer limitation should be updated and increased to at least nine transfers per month, while still making a distinction between savings and transaction accounts.

5. **Seek added flexibility for credit unions that offer member business loans.** These improvements could include: (1) securing credit union-friendly changes to the waiver process; (2) increasing the general minimum loan-to-value ratio from 80% to 85%; and, (3) securing removal of the 5 year relationship requirement.

6. **Update the requirement to disclose account numbers to protect the privacy of members.** Credit unions are currently required to list a member's full account number on every periodic statement sent to the member for their share accounts pursuant to Regulation E. These requirements need to be updated to allow the credit union to truncate account numbers on periodic statements in order to protect the privacy of the member and to reduce the risks of fraud and identity theft.

7. **Update advertising requirements for loan products and share accounts.** The regulatory requirements for advertisement of credit unions' loan products and share accounts have not kept pace with technological changes in the current market place. The requirements of Regulation Z and Truth in Savings should be updated to reflect these changes and advances in practical advertisements and the disbursement of information, while maintaining the integrity and accuracy of the information that the member truly needs to know from the advertisement.

8. **Modernize NCUA advertising requirements** to keep up with technological changes and an increasingly mobile membership. Update NCUA regulations to clarify that the official sign is not required to be displayed on (1) mobile applications, (2) social media, and (3) virtual tellers.

9. **Seek improvements to the Central Liquidity Facility** by reducing the amount of time that it takes for a credit union to secure access to liquidity. In addition, work with the NCUA to secure changes the Central Liquidity Facility by removing the subscription requirement for membership and permanently removing the borrowing cap.

10. **Obtain flexibility for federal credit unions to determine their choice of law.** Federal credit unions should be allowed the opportunity to choose the jurisdiction under which they operate without surrendering their federal charter. To this end, NAFCU will work with the NCUA to establish a waiver process under which a federal credit union, taking into account safety and soundness considerations, would choose the state law under which it wants one or more of its operations.

11. **Update, simplify and make improvements to regulations governing check processing and funds availability.** These enhancements should include: changing outdated references (i.e., references to non-local checks); changes that are required by statute and are already effective and incorrectly stated in the regulation; and changes that enable credit unions to address fraud.

12. **Eliminate redundant NCUA requirements to provide copies of appraisals upon request.** Credit unions are required to provide copies of appraisals under the CFPB's final mortgage rules upon receipt of an application for certain mortgages. The NCUA's requirements to provide a copy upon request should be amended to remove this duplicative requirement.

National Association of Home Builders

Statement of the National Association of Home Builders

"Who's in Your Wallet: Examining How Washington Red Tape

Impairs Economic Freedom"

Hearing before the House Financial Services Committee

April 8, 2014

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement to the House Financial Services Committee. NAHB represents over 140,000 members involved in home building, remodeling, multifamily construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction.

The ability of the home building industry to meet the demand for housing, including addressing affordable housing needs, and contribute significantly to the nation's economic growth is dependent on an efficiently operating housing finance system that provides adequate and reliable credit to home buyers and home builders at reasonable interest rates through all business conditions. At present, home buyers and builders continue to confront challenging credit conditions weighed down by overly strict underwriting requirements that have been exacerbated by an uncertain future regulatory environment. This statement will examine several areas where government regulation has impacted the ability of the home building industry to recover from the recent economic downturn and meet the credit needs of this important sector of the economy.

Demographic and Economic Overview

The underlying demographics of the U.S. support a continuing rise in demand for housing over the next two decades. A combination of record births and past immigration will produce over four million people moving into prime household formation ages every year for at least the next twenty years. These young people, primarily the children of the baby-boom generation, will form their own households as they age into the 25- to 34-year old cohort. These younger households were among the hardest hit by the economic recession, reducing household formation rates by more than most other age groups.

While older households have largely recovered from household arrangement setbacks, younger households are still struggling to return to pre-recession headship rates. And despite having lower headship rates than older segments of the population, these younger households are

expected to add 2.4 million units to total housing demand over the next 10 years. Given their economic vulnerability, affordability will be key to recovery for these households.

Most newly formed households are just beginning their employment career and will not have large down payments or lofty credit scores. Current extra tight underwriting standards have made mortgage attainment even more difficult for younger families. Student debt responsibilities and lower starting salaries and wages compound the difficulty for younger individuals to transition to home ownership.

In addition to the oncoming demand, NAHB estimates that two million households did not form during the recession and represent an additional pent up demand that will come to the housing market as the economy improves and hiring returns to more normal levels. Many young and not so young individuals either did not launch into an independent household or returned to live with their parents, relatives or friends after losing their job or experiencing a significant reduction in income. NAHB expects these individuals to establish their own home and be in the market for an apartment or owned home as the economy expands.

Providing affordable homes will also present a challenge to home builders as the cost of housing production rises. Builders are paying more for labor, land and building materials. As discussed later, builders continue to have difficulty accessing production credit from the traditional financial institution sources and have turned to non-traditional equity and debt sources that cost more.

Factors Constraining Availability of Mortgage Credit

While mortgage rates remain near historically low levels, access to mortgage credit is limited to those with pristine credit histories who can qualify for government-backed programs. Presently, FHA, VA, Fannie Mae and Freddie Mac (the Enterprises) account for more than 90 percent of mortgage originations.

Today's tight lending conditions are keeping more buyers on the sidelines even as the housing market recovers. As discussed below, lender credit overlays, increased fees, significant new regulations and other factors continue to impact the availability of mortgage credit. At a time when housing affordability has been at record favorable levels and mortgage rates are near historic lows, more buyers should be entering the housing market. However, many creditworthy borrowers are not able to take advantage of these opportunities. As new rules are implemented, consideration should be given to how this increasingly imposing regulatory environment will adversely impact the availability of mortgage credit and impede housing market and economic activity.

Lender Credit Overlays and Buy Back Risk

Lender overlays in the mortgage credit process have been a major factor in the greater difficulty potential home buyers are having in obtaining financing as lenders are imposing credit underwriting standards that are more restrictive than FHA, VA, Fannie Mae and Freddie Mac require. These credit overlays are employed due to heightened lender concerns over forced loan buy-backs on mortgages sold to Fannie Mae and Freddie Mac and/or greater required indemnifications on FHA-insured and VA-guaranteed loans.

When lenders sell loans to entities, such as Fannie Mae and Freddie Mac, and through the FHA/VA/Ginnie Mae securities process, they are required to make assurances that they have performed the appropriate level of due diligence on the loan application, and the lenders agree to buy back a loan if it is discovered that they were at fault in their underwriting process. These

representations and warranties ("reps and warrants") have been a standard practice in mortgage lending.

In the aftermath of the collapse in the housing market, the underwriting of delinquent loans was alleged to not meet the established criteria of FHA, the Enterprises, and other secondary market entities. As a result, lenders have faced a protracted fight with these agencies about the buyback of loans that have been deemed ineligible for Enterprise guarantees or government insurance based on the finding of faulty due diligence practices. Lenders complain that the criteria triggering buy-back demands by Fannie Mae and Freddie Mac and insurance claims rejections by FHA and VA are unclear and inconsistent. The resulting uncertainty has caused lenders to employ underwriting standards that are more restrictive than those required by FHA, VA, Fannie Mae and Freddie Mac. These lender "overlays" have closed the credit window to many aspiring home buyers who actually meet the loan qualification requirements established for these programs.

While FHA and the Federal Housing Finance Agency (FHFA), which regulates Fannie Mae and Freddie Mac, have announced efforts to encourage lenders to refrain from excessive mortgage credit requirements, lender concerns about how federal agencies will implement repurchases and indemnifications continue to constrain credit availability. This is evidenced by the sharp increase in borrower credit scores since 2001. A recent report from the Urban Institute (UI) found that "In 2001, 24 percent of purchase loans had FICO credit scores under 660, but that share dropped to 13 percent in 2012, and further to 10 percent in 2013. The share of loans with FICOs greater 750 increased from 31 percent in 2001 to 45 percent in 2012 and 47 percent in 2013."[1] The UI report estimates that as many as 1.22 million fewer mortgage purchases were made in 2012 than would have been made had credit availability been the same as in 2001.

According to the 2013 State of the Nation's Housing Report, these trends largely reflect the evaporation of loans to borrowers with weaker credit histories. "In 2007, borrowers with credit scores below 620 accounted for 45 percent of FHA loans. By the end of 2012, that share was under five percent."[2] Similar trends are evidenced in the share of first-time home buyers which accounted for 27 percent of home sales in December 2013, well below the historical average of about 40 percent.

Loan Limits

The maximum loan amount, or loan limit, is a key factor in determining whether a borrower will qualify for a government (FHA, VA), Fannie Mae or Freddie Mac loan program which carry lower interest rates than non-government backed programs. Recent changes to the FHA loan limits significantly lowered loan limits throughout the country. FHFA is contemplating lower loan limits for Fannie Mae and Freddie Mac. NAHB opposes lowering the loan limits because this will result in fewer loans being eligible for government or government-sponsored loan programs, reducing the overall availability of affordable mortgage credit.

On January 1, the maximum mortgage amount for FHA-insured single-family loans decreased by more than $100,000 due to the expiration of temporary increased limits set during the housing crisis. As required by the Housing and Economic Recovery Act of 2008 (HERA), the new national ceiling loan limit for the nation's highest cost areas has been reduced from $729,750 to $625,500. The current standard loan limit (or floor) for areas where housing costs are relatively low remains unchanged at $271,050. In addition, the formula for setting FHA loan

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[1] Urban Institute Housing Finance Policy Center Commentary, "Where Have All the Loans Gone? The Impact of Credit Availability on Mortgage Volume", March 2014.

[2] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2013*, page 19.

limits in individual areas where median home prices are above the floor changed from 125% to 115% of the area median home price. Loan limits in more than 600 counties nationwide have decreased as a result.

A number of areas experienced limit drops far greater than what was anticipated based on the statutory change in the loan limit calculation, while some areas actually gained higher limits. These unexpected results are due to a change in HUD's methodology for determining the level of area median home prices.

An analysis by NAHB indicates that, relative to 2013, loan limits dropped by more than 10 percent in more than 400 counties, and more than 100 counties had a drop of more than 30 percent. On the whole, the lower price limits will make it more difficult for first-time home buyers to purchase a home, particularly in job producing high cost areas of the nation. This will reduce housing demand and slow the recovery in housing, especially among younger prospective buyers who are seeking to start their careers, get married and have children.

NAHB appreciates the efforts of Representatives Gary Miller (R-CA), Brad Sherman (D-CA), and Carolyn Maloney (D-NY) for introducing the *Stabilizing FHA Loan Limit Calculations Act of 2014* (H.R. 4208) that will address these unprecedented changes that are creating an environment of buyer and lender uncertainty in the housing market. With the availability of mortgage credit already overly restrictive, NAHB looks forward to working with the committee to advance H.R. 4208 and ensure that HUD policies do not put homeownership out of reach for many American families.

Lower loan limits for Fannie Mae and Freddie Mac are being contemplated, as well. While the 2014 baseline maximum conforming loan limit for mortgages acquired by Fannie Mae and Freddie Mac will remain at the statutory maximum of $417,000, with high cost area limits up to $625,500, until Oct. 1, 2014, FHFA has requested comments on a proposal to subsequently reduce Fannie Mae's and Freddie Mac's loan limits by 4 percent across the board. NAHB strongly opposes this plan and submitted comments on March 20, 2014 urging FHFA not to reduce the limits below the statutorily-mandated maximums.

Fees

Fees for government-backed mortgages continue to be at an increased level, even though the credit quality of the underlying loans is very high, as evidenced by the high FICO scores referenced earlier. These higher fees are usually passed on to consumers, making it more expensive for borrowers to obtain a home loan or, in some cases, even preventing them from qualifying for a loan.

Since 2010, FHA has significantly increased their upfront and annual mortgage insurance premiums (MIP). The annual MIP on a typical FHA loan (LTV less than 95 percent and loan amount below $625,500) has nearly tripled and is presently 130 basis points compared to 50 basis points in April 2010. The upfront MIP has increased to 175 basis points from 100 basis points in 2010. Further, last year, FHA terminated the policy that allowed borrowers to stop paying mortgage insurance premiums after their loan reaches 78 percent of its original value. As a result, the cost of an FHA loan over the life of the loan is higher than that of a conventional loan with private mortgage insurance which borrowers can stop paying when the LTV reaches 78 percent of original value.

At the direction of the FHFA, Fannie Mae and Freddie Mac have been increasing their guarantee fees (g-fees) that are charged to lenders to protect against credit-related losses.

Guarantee fees are now around 50 basis points – nearly double their level prior to the Enterprises being placed in conservatorship in September 2008.

In addition to the guarantee fees, Fannie Mae and Freddie Mac continue to charge adverse market fees and loan level pricing adjustments. Fannie Mae and Freddie Mac have charged a 25 basis point adverse market fee since March 2008 for whole loans and mortgage loans delivered into MBS. The loan level price adjustments, which have been charged since 2009, add delivery fees to mortgages purchased by the Enterprises. The delivery fees which vary based on credit score and loan-to-value ratio range from 25 to 325 basis points. This translates into a 6 to 80 basis point increase in mortgage financing costs.

In early December 2013, FHFA announced plans to impose additional fee increases. FHFA directed Fannie and Freddie to raise g-fees in three segments, including a 10-basis point increase for all mortgages, and up to a 150 basis point increase in loan delivery fees. FHFA estimated that the changes would have increased mortgage rates by 11 basis points. However, independent analysis found that the increase would have been significantly higher for the most negatively impacted borrower pools, those with credit scores from 680 – 759 and 5 – 20 percent downpayment. The higher fees would have increased borrowing costs for these borrowers by roughly 20 to 40 basis points.

In January, FHFA Chairman Watt announced that he was delaying the implementation of the higher fees until he could fully evaluate the rationale for the higher fees and the impact on the cost and availability of mortgage credit. While NAHB appreciates Chairman Watt's decision to delay the fee increases, we question the need to continue the additional adverse market charges and loan level delivery charges. These fees were originally implemented to better align mortgage pricing with credit risk. With declining foreclosure and delinquency rates and improving profitability at Fannie Mae and Freddie Mac, FHFA should roll back these charges.

Appraisals

The current residential appraisal system is impaired due to inconsistent and conflicting standards and guidance; inadequate and uneven oversight and enforcement; a shortage of qualified and experienced residential appraisers; and, the absence of a robust and standardized data system. NAHB believes these problems must be addressed in order to restore confidence in the residential real estate market and to establish a foundation for sustainable growth of the U.S. economy. This can only be accomplished through sound valuation practices, policy, and procedures that produce more credible valuations under all economic circumstances. NAHB is committed to residential appraisal reform and looks forward to working with industry stakeholders to address the problems and implement solutions to the current U.S. residential appraisal system.

The establishment of a single set of rules and appraisal forms should be incorporated as a high priority as part of housing finance system reform. These rules and forms should be guided through input from industry stakeholders to ensure the rules and forms meet the needs of all industry participants and serve to avoid collateral risk in the new housing finance system. Currently, Fannie Mae and Freddie Mac impose de facto appraisal authority through the guidelines they have established for appraisals on the mortgages they purchase and the forms they use to collect appraisal information. These Enterprise appraisal rules tend to restrict appraisers' ability to pursue approaches that could result in more accurate valuation. In addition, confusion arises in how to interpret the Enterprise appraisal guidelines in relation to the rules established by The Appraisal Foundation (TAF) in the Uniform Standards of Professional Appraisal Practice (USPAP) and the appraisal regulations of the banking regulators.

In addition, NAHB believes it is extremely important to establish a timely value appeals process that is fair, balanced and appropriate to allow all parties to the transaction to appeal appraisals that do not meet USPAP standards or are based on inaccurate data or assumptions. The banking regulators could assist in this area by directing the financial institutions they regulate to develop and implement a value appeals process.

Regulatory Constraints

The regulatory environment for mortgage lending is undergoing significant changes as regulators implement new rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Uncertainty about the eventual regulatory landscape is another key factor that has tightened access to mortgage credit. Attempts by lawmakers and regulators to prevent a repeat of the housing boom/bust and the financial crisis by purging risk from mortgage lending has further tightened the credit box.

Total loan production costs continue to escalate and NAHB is concerned about the impact of the additional regulatory cost to originate loans in today's environment, particularly for smaller banks and independent mortgage bankers. Many of these smaller originators serve rural communities, first-time homebuyers and other underserved market segments and NAHB members are hearing that many smaller banks and independent mortgage bankers are choosing to depart the residential mortgage business. This exodus will cause less competition and provide consumers with fewer choices.

NAHB supports steps to ensure that mortgage lending occurs in a safe and sound manner, with appropriate underwriting, prudent risk management and sound consumer safeguards and disclosure. NAHB believes that loans should be carefully underwritten and adequately disclosed. NAHB also believes that it is critical that mortgage lending reforms are imposed in a manner that causes minimum disruptions to the mortgage markets, while ensuring consumer protections.

Ability to Repay Rule

The implementation of the final Ability to Repay (ATR) standard by the Consumer Financial Protection Bureau (CFPB), which took effect on January 10, 2014, has alleviated some of the regulatory uncertainty by defining new requirements and liabilities on lenders. However, the rule has created new hurdles for borrowers, especially low- to moderate-income buyers and self employed borrowers that are under increased scrutiny due to the debt-to-income calculation and stringent documentation requirements.

The ATR rule establishes standards for complying with the ability-to-repay requirement by making a "qualified mortgage" (QM). The QM standard is intended to balance protecting consumers from unduly risky mortgages and providing lenders more certainty about potential liability. Lending outside the QM box is still allowed, and in fact, the CFPB is encouraging lenders to make non-QM loans. Lenders, however, must balance being exposed to increased litigation risk with expanding their product offerings. To the extent that lenders will remain cautious during the transition and beyond, creditworthy borrowers may not have access to affordable mortgage credit, or may be left out of the credit box all together

NAHB appreciates the U.S. Department of Housing and Urban Development (HUD) release of a separate QM definition for loans insured or guaranteed by the agency, such as FHA loans. As the HUD QM allows for lenders to follow current FHA underwriting criteria, this has helped keep credit flowing.

It is important to note that the ATR includes a seven year window in which loans that are eligible for purchase by Fannie Mae and Freddie Mac are considered qualified mortgages. This provision of the ATR rule has helped to ensure the continued flow of credit through this transition period. As Congress actively debates the future of Fannie and Freddie, the interconnectedness of the Dodd-Frank regulations with the current structure of the housing finance system must be considered.

Qualified Residential Mortgages

A critical mortgage regulation mandated by Dodd-Frank - the Credit Risk Retention rule – has yet to be finalized. NAHB was pleased last August when the six federal agencies responsible for implementing the credit risk retention requirements re-issued a proposed rule with a revised definition of a "qualified residential mortgage" (QRM) that would equate with the definition of the QM. Aligning the QRM with the QM has many benefits. Establishing one streamlined regulation, instead of having two separate sets of underwriting criteria, will alleviate confusion in the marketplace and will help provide clarity and transparency for home buyers, lenders, investors and other housing market participants. Additionally, the underwriting criteria and product limitations contained in the QM will promote more prudent lending and will provide investors with an assurance that the loans are sustainable.

NAHB is supportive of ensuring safe, well documented, and soundly underwritten loans without limiting the availability, or increasing the costs of credit to borrowers. Aligning QRM with QM levels the playing field, promotes liquidity in the mortgage market and allows access to credit for a diverse range of home buyers, particularly first-time and low- to moderate-income home buyers. If the QRM is too restrictive, this important group of home buyers will have to rely on government programs or potentially risky mortgage products for low downpayment options. Encouraging private capital to provide mortgages with reasonable terms to a broad range of home buyers is imperative to support a sustained housing market recovery.

Regulatory Barriers to Housing Production Credit

Despite signs of improvement in recent months, many home builders continue to deal with a significant adverse shift in terms and availability on land acquisition, land development and home construction (AD&C) loans and builders with outstanding loans have faced numerous challenges. Lenders are reluctant to extend new AD&C credit or to modify outstanding AD&C loans in order to provide more time to complete projects and pay off loans. Lenders themselves often cite regulatory requirements or examiner pressure on banks to shrink their AD&C loan portfolios as reasons for their actions. While federal bank regulators maintain that they are not encouraging institutions to stop making loans or to indiscriminately liquidate outstanding loans, reports from NAHB members in a number of different geographies continue to suggest that bank examiners in the field have adopted a more aggressive posture.

While the home building industry is no longer experiencing the dramatic declines in the outstanding stock of AD&C loans that immediately followed the economic downturn, there still exists a lending gap between home building demand and available credit. Since the beginning of 2007, the dollar value of the pace of single-family permitted construction is down 39 percent. During this same period, home building lending for AD&C purposes is down 78 percent. This lending gap is being filled by other sources of capital, including equity investments from non-depository institutions and lending from other private sources, which may generally offer less favorable terms for home builders than traditional AD&C loans.

The home building industry is predominantly made up of small businesses and these companies have traditionally relied on community banks for AD&C loans. With regulatory pressures

unfortunately still impacting the cost and availability of construction credit, congressional action is needed to help open the flow of credit to home builders. Without such action, there can be no sustainable housing recovery, which has major implications for our nation's ability to recover from the economic downturn.

NAHB appreciates the efforts of Representative Gary Miller (R-CA) and Carolyn McCarthy (D-NY) for introducing The *Home Construction Lending Regulatory Improvement Act of 2013 (H.R. 1255)* that would address several regulatory barriers to sound construction lending, and looks forward to working with this committee to advance regulatory reform in this area. Going forward, it does not seem likely that community banks will again resume the levels of AD&C lending previously undertaken unless some form of secondary market outlet is created to allow these institutions to sell their AD&C output and obtain liquidity for additional lending.

NAHB is also very supportive of H.R. 1553, the *Financial Institutions Examination Fairness and Reform Act* introduced by Financial Institutions Subcommittee Chairman Shelley Moore Capito (R-WV) and Representative Carolyn Maloney (D-NY), that would provide new standards for bank examinations. Of particular note to the home building industry, such new standards would specify that a commercial loan (including AD&C loans) cannot be placed in nonaccrual status solely because the collateral has deteriorated in value. Additionally, the legislation would clarify that a new appraisal is not required on a commercial loan unless an advance of new funds is involved. Last July, H.R. 1553 was incorporated into H.R. 2767, the *Protecting American Taxpayers and Homeowners Act of 2013 (PATH Act)*. While there are policy elements of the PATH Act that NAHB supports, we strongly oppose the legislation because of its lack of federal support for housing. NAHB looks forward to working with the committee to advance key elements of our AD&C credit crisis legislative agenda.

Conclusion

NAHB appreciates the Financial Services Committee's focus on regulatory activities that are adversely impacting the economy. Housing is an important source of economic growth and job creation; and regulations are limiting home builders' ability to grow and contribute positively to the economy.

As of the final quarter of 2013, housing's share of gross domestic product (GDP) was 15.3 percent, with home building yielding 3.1 percentage points of that total. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 percent and 13 percent, for a combined 17 percent to 18 percent of GDP. While these shares tend to vary over the business cycle, clearly housing is an important factor in a healthy economy. Job creation is one of the important ways that housing contributes to GDP. NAHB estimates that building an average new single family home creates 3.05 jobs; building an average new multifamily rental unit creates 1.16 jobs; and every $100,000 spent on residential remodeling creates 1.11 jobs. Therefore, the cost and availability of credit for builders and home buyers has a direct impact on the ability of housing to contribute to economic growth.

Yet, the home building industry continues to confront significant regulatory headwinds. Along with the challenges that builders face in securing financing, new regulations are being developed that impact all aspects of home building. For instance, the housing and construction industry is actively engaged with OSHA, EPA and other agencies on new regulations which could drive up the cost of housing further. All of these issues must be factored into the cost of housing. As the cost of housing increases and the credit box remains tight, home buyers and renters will have fewer safe, decent and affordable housing options.

NARCA
NATIONAL ASSOCIATION OF RETAIL COLLECTION ATTORNEYS

Testimony of Joann Needleman
President of the National Association of Retail Collection Attorneys
Before the United States House Committee on Financial Services

Who's In Your Wallet:
Examining How Washington Red Tape Impairs Economic Freedom
April 8, 2014

Introduction

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to offer testimony regarding the economic consequences of recent rulemaking and supervisory and enforcement actions. It is my privilege to serve as President of the National Association of Retail Collection Attorneys ("NARCA").

NARCA is a not-for-profit trade association comprised of over 700 law firms engaged in the practice of consumer debt collection law. Attorneys employed by NARCA member law firms are committed to the fair and ethical treatment of all participants in the debt collection process. As officers of the court, they must adhere to applicable state and federal laws, rules of civil procedure, state bar association licensing and education requirements and the rules of professional conduct.

NARCA has a significant interest in ensuring that Consumer Financial Protection Bureau ("CFPB") rulemaking is consistent with NARCA members' professional responsibilities to their clients, the courts, consumers and the general public. NARCA does support reasonable rulemaking that ensures consumers are adequately protected, provided such measures do not unduly burden legitimate debt collection.

As a preliminary matter, the CFPB asserts that its authority to regulate the practice of law by collection attorneys derives from the Dodd-Frank Act. NARCA does not concede this point and has submitted comments on this issue in response to CFPB rulemaking. While these arguments are outside the scope of this hearing, I think it is important for the Committee to understand that the premise of CFPB regulation of attorney conduct is not without controversy.

Effect of Regulation on Law Firms

NARCA's membership is largely comprised of law firms which, in terms of size, would be considered small businesses. Over 63% of NARCA members have twenty-five employees or less. President Obama stated in 2010 that small businesses (which presumably include small law firms) are "the backbone of our economy and the cornerstones of our communities." And yet, when I look at the effect of CFPB regulation, I know first-hand that these smaller law firms are bearing the brunt of the burden.

As President of NARCA I am told with increasing frequency about smaller law firms that are "folding" or changing practice areas because of the compliance costs associated with new regulations. These firms employ hard-working men and women who are not only lawyers, but also individuals in IT, bookkeeping, human resources and compliance. Many of these firms have been in existence for over 20 years. They have always been compliant with state and federal laws and have never had any action brought against them under the Fair Debt Collections Practices Act or other consumer protection laws. Nevertheless, in the past year a number of these law firms have received letters from significant clients telling them in so many words "thanks, but no thanks." While the work of these firms was exemplary in every respect, the cost of compliance was just too expensive and the risks too great. Larger participants, seeing declining revenues due to compliance requirements and needing to reduce their audit costs, would rather work with five large partners than ten smaller ones. It's the classic story of the little guy (or girl) who just can't compete and is now left out of the game.

At a CFPB Field Hearing last July, Director Cordray stated that "there is no reason why debt collectors cannot treat consumers with dignity and respect, even as businesses are able fairly to collect the money that is actually due to them." While I agree wholeheartedly with Director Cordray's remarks, the current regulatory scheme cannot achieve the unachievable. What the CFPB wants is better customer service from the debt collection industry; a Main Street perspective. But how can you achieve that personal level of service when the only way to succeed is to use the Wall Street Model and employ hundreds, if not thousands of people who will never talk to the same consumer twice? It's like comparing a "big box" retailer to a local proprietor: Sure, the "big box" is cheaper, but you know the corner store will do a better job of dealing with a problem.

Dodd-Frank was enacted to prevent "too big to fail." Small businesses and law firms in the debt collection industry are losing their ground in this current regulatory environment because, sadly, they are simply "too small to succeed."

NARCA agrees with the U.S. Chamber of Commerce that it is of the utmost importance that "the CFPB approaches rulemakings with the highest sensitivity towards the Bureau's impact on small businesses." Further, it should be mandatory that the CFPB solicit public feedback on the consequences, intended and unintended, on small businesses at a fixed point in time following implementation of a final rule. This requirement should be in conjunction with a post-implementation review by a Small Business Advocacy Review Panel.

How much has the cost of compliance increased for collection law firms? NARCA asked that question of its members in preparation of its response to the CFPB's recent Advance Notice of Proposed Rulemaking ("ANPR"). NARCA members report that over the past three years the cost of compliance has increased 327.1%

Effect of Regulation on Consumers

Every collection attorney will tell you that communication is the key for consumers to resolve their debts. Whether the debt is admittedly owed or is in question, resolution is achieved through interaction between the consumer and the collector. The CFPB should be more proactive in encouraging this communication. Instead, the tone and spin of the CFPB's press releases, bulletins and testimony is far more likely to strike fear into the hearts of consumers and discourage these conversations. In fact, the CFPB has published template letters that consumers may use to communicate with debt collectors. These letters, drafted without any industry input, are designed to halt communication between consumers and debt collectors.

Participants at both the FTC-CFPB Roundtable and NARCA's Legal Symposium on Consumer Debt Collection explained that debt collectors have three avenues to collect debt: 1) communicate with the consumer by mail; 2) communicate with the consumer by telephone; and 3) file a lawsuit against the consumer if the consumer refuses to communicate. The lawsuit avenue is seldom a preferred choice for consumers, creditors or collection attorneys. Any opportunity to achieve resolution prior to suit generally inures to the benefit of all in terms of cost, convenience and outcome. Thus, it is not surprising that NARCA members reported in response to the ANPR that it is over 80% more likely a collection lawsuit will be filed if a consumer refuses to communicate. Further, the ANPR responses show that settlement terms are significantly more favorable to consumers if negotiated prior to the filing of a lawsuit than after.

The NARCA Legal Symposium on Consumer Debt Collection, held in October 2013 at The George Washington University, included a panel entitled "Legal Collections: The Essential Link to a Successful Credit-Based Economy." Panelists included Dr. William

Dunkelberg (Professor of Economics, Temple University), Troy Paredes (former Commissioner, SEC), Alfred Pollard (General Counsel, FHFA) and Todd Zywicki (Professor, George Mason University School of Law). In summary, the panelists explained that the availability of credit improves consumers' overall quality of life and allows businesses to operate more efficiently. However, as regulatory requirements begin to mount, those who were intended to benefit from the regulation begin to bear some of the burden. Debt collection regulations raise the cost, legal and otherwise, of providing credit and reduce the recovery of debt per dollar of effort expended. The end result is a decrease in the availability of credit to consumers.

The conclusions of the panelists are supported by a Working Paper (No. 13-38) published by the Federal Reserve Bank of Philadelphia in May 2013. The author stated:

> The effect of debt collection restrictions on the number of revolving lines of credit is negative, statistically strong, and economically significant. . . Robust contract enforcement can help explain the existence of large and active retail credit markets and contribute to our understanding of how these markets function. In terms of policy implications, my results indicate that financial regulation that institutes strong consumer protection must be balanced with creditor rights in order for the latter to extend consumer credit in the first place.

Conclusion

Thank you for the opportunity to offer this testimony. NARCA is committed to working with the CFPB to ensure rulemaking strikes the proper balance between consumer protection and preservation of creditors' rights and the availability of affordable consumer credit. Small businesses and law firms should not fail simply because they are "too small to succeed."

Statement of the U.S. Chamber of Commerce

ON: "Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"

TO: House Committee on Financial Services

DATE: April 3, 2014

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting, and defending America's free enterprise system, believes that effective regulation is needed to ensure the safety and soundness of the financial markets. The Chamber would like to thank you and the members of the House Financial Services Committee for your continued work and focus on issues of importance to the competitiveness of our capital markets. Sound and balanced regulatory structures are needed for these markets to spur growth and create jobs in a global economy.

In 2007, in order to achieve these goals, the Chamber established the Center for Capital Markets Competitiveness (CCMC) to advocate for the replacement of the existing early twentieth century era financial regulatory system with one to effectively regulate a globally competitive twenty-first century economy. Since that time, the CCMC has worked with the various regulators to promote policies for greater transparency, eliminate regulatory dead-zones, and increase coordination amongst agencies while encouraging greater consumer protection and capital formation. The CCMC has filed well over 500 comment letters and had hundreds of meetings with regulators in this effort.

While some of these efforts have been more successful than others, we would like to share some of the Chamber's experiences as you review the efforts by the banking regulators to oversee the marketplace. We have found that each regulatory agency is different, where some agencies will attempt to regulate through enforcement actions instead of rule-writing, while other agencies have flawed rule-writing processes that do not adhere to statutory requirements. In either case, the outcome is the same: unclear or unworkable rules that hamper the ability of businesses to operate while hindering effective consumer and investor protection.

The Chamber is grateful for the Committee's attention to these issues and welcome the opportunity to provide this statement for the hearing record, which includes nine case studies for your consideration. Each describes an example of agency overreach, the use of a shortcut, or a lack of coordination that threatens to impede capital formation, harm Main Street businesses, or reduce credit options for consumers.

A. Regulating Consumer Credit

We recognize that rulemaking can be time-consuming and that regulators may find other means of setting clear standards to be more effective in certain situations.

But this is no excuse for making regulatory policy behind closed doors. Nor does it justify adopting policies that have been shielded from public comment and economic analysis. This is not how the regulatory system is supposed to function, and for good reason. As the Bipartisan Policy Center explained in the case of the Consumer Financial Protection Bureau (CFPB), using transparent and inclusive procedures generates better outcomes:

> [W]hen the Bureau operated in a transparent, open, and iterative manner, repeatedly seeking input from all stakeholders throughout a process, the results were generally positive. However, **when the Bureau made unilateral decisions, rolled out initiatives, rules, or processes as a result of a more closed, internal deliberation process, the results were far more likely to be problematic.** Sometimes the Bureau went back, sought input, and improved the end result. Sometimes it did not.[1]

Although other financial regulators have made similar mistakes, CFPB unfortunately has been particularly weak in its commitment to transparent and inclusive regulatory policy making. As we explained in a letter to Director Richard Cordray on February 12, 2014, the Chamber is seriously concerned by the Bureau's failure to work toward clear, evenly applied, economically sound standards.[2] CFPB has a variety of tools that would allow it to explain the requirements of statutes and regulations within its jurisdiction. Nonetheless, despite repeated and often bipartisan requests for greater transparency, CFPB frequently has chosen to make regulatory policy without obtaining public input or committing to a clear statement about what the law requires.[3] As a result, CFPB has made it virtually impossible for companies to determine in advance what they should do to comply with the law. Faced with regulatory uncertainty and the real potential of enforcement actions that inflict substantial reputational risk, some market participants are simply abandoning consumer lending in areas that are not core to their business. The result is fewer choices, less competition, and higher costs for consumers.

1. Indirect Auto Lending

[1] Bipartisan Policy Center, *The Consumer Financial Protection Bureau: Measuring the Progress of a New Agency*, at 5 (Sept. 2013) (emphasis added).
[2] It is no coincidence, we believe, that a regulator that is so free from the checks normally provided by other elements of the federal government would make policy in a manner that disclaims any responsibility or accountability to Congress, the public, or other stakeholders.
[3] Congress granted the Bureau broad power to promulgate rules as well as authority to issue clarifying guidance, interpretations, and statements of policy. *See* Pub. L. 111-203 § 1012(a)(10), § 1022 (2010).

The Equal Credit Opportunity Act (ECOA) prohibits lenders from discriminating on the basis of race, sex, and other similar grounds against otherwise creditworthy individuals. The text of the statute prohibits intentional discrimination and the Chamber strongly supports efforts to detect and punish such discrimination; but the statutory text does not impose liability if a facially nondiscriminatory practice has a disparate impact on a group protected by the statute. The Bureau nonetheless has moved—without undertaking a rulemaking on the subject—to impose disparate impact liability on indirect auto lenders through a March 21, 2013 bulletin on "Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act."

More specifically, CFPB is seeking to regulate the practices of auto dealers—over whom it has no jurisdiction—by holding liable the banks and other financial institutions that provide auto loans. CFPB claims that the industry's long-established method of compensating dealers for their role in bringing together lenders and auto purchasers, an amount typically set by the dealer and paid by the consumer, could be used to prove disparate impact discrimination by the banks and financial institutions. The Bureau does not believe that it must prove intentional discrimination. Nor is it material to the Bureau that the financial institutions did not know of the claimed discrimination or that each institution has clear policies forbidding discrimination.

CFPB instead believes that it may find an ECOA violation whenever the Bureau's unproven "proxy" analysis for determining "race and national origin probabilities" indicates that dealer compensation resulted in statistically significant differences in the interest rates paid by different demographic groups, and that those differences were not the result of other legitimate pricing variables. By taking this position, CFPB has created enormous uncertainty in the auto finance market, threatening to raise the cost of credit and drive the industry to untested business models that could be harmful to consumers.

These concerns have resonated broadly in this Committee and elsewhere in both the Senate and the House of Representatives. Congress, of course, could have included a provision in the Dodd-Frank Act that imposed disparate impact liability on indirect auto lenders or on auto dealers. It did not. In fact, that Act specifically carved out dealerships engaged in indirect auto financing from the Bureau's jurisdiction.[4] Given this clear expression of congressional intent—as well as the obvious implications for the availability of credit and harm to small businesses—Members of Congress have been concerned, on a bipartisan basis, about the Bureau's disruption of the auto finance market.

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[4] Pub. L. 111-203 § 1029 (2010).

Thus, CFPB has received requests for explanation from Members of Congress, both at hearings and in bipartisan letters with numerous signatories. These letters have come from a majority of the members of this Committee, a group of twenty two Senators, and sixteen members of Florida's House delegation who implored CFPB to reverse its previous refusals to provide anyone with the raw data and analytical methods it is using in its disparate impact analyses.[5] In a time of sharp political disagreements, these Members have been able to agree that the Bureau must explain the legal and factual bases for its actions, and why it is creating a very significant incentive for adoption of alternatives to the business models that currently prevail in today's highly efficient auto finance market, alternatives that are likely to restrict credit availability and increase cost.

If CFPB persists in attempting to change the prevailing method by which indirect finance sources compensate dealers for arranging financing for consumers, it should undertake a rulemaking to address the legal, analytical, and practical questions raised by Members of Congress and by market participants to ensure consumers are not needlessly impacted.[6] The Bureau has not done so, however, fostering rather than eliminating ambiguity on this topic.

As a result, important questions remain unanswered. For example:

- Financial institutions do not deal directly with the auto purchasers who are obtaining credit; the auto dealers perform that role—and the law does not permit auto dealers to record information regarding the race, gender, or other characteristics of every auto purchaser; or to provide that information to the financial institutions. Given that reality, how are financial institutions supposed to reliably determine whether there is an impermissible disparate impact, let alone guard against that possibility in the future?

- CFPB's methodology for calculating disparate impact —which relies upon "proxies" (such as name and residence address) to determine an auto purchaser's race and gender, and unknown control factors that lead CFPB to conclude that pricing disparities are the result of discrimination—has never been fully explained, and therefore cannot be replicated by indirect lenders that seek to evaluate their portfolios to ensure that auto dealer

[5] *See* Letter from Representative Sewell and Representative Scott to Director Richard Cordray (May 31, 2013); Letter from Representative Bachus and Representative Capito to Director Richard Cordray (June 20, 2013); Letter from Senator Portman and Senator Shaheen to Director Richard Cordray (Oct. 30, 2013); Letter from Representative Alcee Hastings and Representative Posey to Director Richard Cordray (Dec. 18, 2013).

[6] The Bureau clearly recognizes its authority over this subject since in 2011 it reissued the implementing regulation for ECOA. *See* 76 Fed. Reg. 79442 (Dec. 21, 2011).

participation in the interest rate is not having a disparate impact. Nor has the Bureau explained what threshold it believes constitutes a statistically significant disparate impact and how it is sure that any such amount is not within the margin of error of its analysis.

CFPB's March 21, 2013, bulletin did not answer these questions.[7] It instead identified a number of steps that lenders could take in hopes of ensuring compliance with ECOA, without any assurance or clarity that these steps would constitute acceptable compliance. The Bureau has said that adoption of flat-fee pricing—requiring auto dealers to charge the same fee to every single customer who obtains financing—would protect indirect lenders against disparate impact liability. That would be a dramatic change in the auto lending market, in which flat fees are not the predominant method of compensating dealers for arranging financing, but CFPB has chosen not to solicit public comments on, and itself has not publicly assessed, the effect on credit availability and cost of the flat fee model it apparently prefers.[8]

The recent enforcement action against Ally Bank demonstrates the very significant problem confronting lenders. The Ally consent order states that the disparities found by CFPB are "statistically significant," that the Bureau identified violations through a proxy methodology described as "the Bayesian Improved Surname Geocoding (BISG) method," and that the explanations offered by Ally did not "appropriately reflect [...] legitimate business needs."[9]

But CFPB's order does not explain:

- How its "proxy methodology" works;
- The error rate anticipated by this proxy methodology and the level of errors at which the underlying conclusions about disparate impact would remain statistically valid;
- What it considers a "statistically significant" disparate impact or even whether it gauges that impact by basis points or another measure;
- What analytical controls it applies to ensure that the consumers from different groups who are being compared are "similarly situated" (i.e., what

[7] CFPB Bulletin 2013-02, Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act (Mar. 21, 2013).
[8] *See* Letter from Director Richard Cordray to Senator Rob Portman and Senator Jeanne Shaheen (Nov. 4, 2013).
[9] Consent Order 6, File No. 2013-CFPB-0010 (Consumer Finance Protection Bureau, Dec. 20, 2013).

analytical controls it is applying to isolate a consumer's background as the sole reason for any statistically significant pricing disparities that the Bureau finds between different groups of consumers);

- What it considers to be "legitimate business needs" that properly may result in pricing disparities; and

- How it concluded that the disparities at issue resulted from the subject lending practices.

Because the analysis and factors used by CFPB remain unknown, no company can build a compliance regime that it knows will satisfy the Bureau. Indeed, the continuing monitoring system imposed under the Ally consent order appears premised on the inevitability of future violations,[10] suggesting that no one—including the Bureau—knows how to ensure compliance going forward.

Lenders that are unwilling to operate under the constant threat of disparate impact liability—and no company wants to be labeled "discriminatory" by a government agency—have two choices: either leave the market or move to a flat-fee model.

CFPB appears not to have considered the consequences of such changes for consumers—even though reduced lender participation and the elimination of price discounting could shrink credit availability and raise consumers' costs. So far, in fact, industry groups have had to fill the void for research into the consumer impact associated with a move to a flat-fee model.[11] Surely that is a matter warranting significant attention from the Bureau.

In recent testimony before this Committee, Director Cordray acknowledged the complexity of this issue, and explained that "... in our bulletin, we made it clear that flat fees are one mechanism by which lenders could address this issue. But it's by no means necessarily the only mechanism. And my real answer to your question is I don't know that we know all the mechanisms yet that would be satisfactory. And we are open to auto lenders, and others, bringing those to our attention."

If the adoption of a flat-fee standard is the Bureau's goal, it should pursue that goal through a rulemaking that fully considers any resulting consumer benefit or

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[10] *See id.* at ¶ 31(f) (providing for remuneration of affected consumers for future "statistically significant dealer markup disparities for that group at or above the agreed upon target").

[11] *See* Press Release, American Financial Services Association, "Vehicle Finance Industry Commissions Study to Address Fair Lending" (Nov. 12, 2013).

harm. If that is not the goal, as your comments above suggest, the Bureau should provide meaningful guidance, whether through rulemaking or less formal means, that allows indirect auto lenders to build effective compliance regimes.

Of course, the problem is not unique to the indirect auto lending market. Wherever CFPB intends to apply complex statistical analysis to enforce a disparate impact standard, it must be transparent about its methodology and carefully, and publicly, weigh the costs and benefits of any policy change—such as flat pricing—that the Bureau's approach would require, whether as a matter of law or as a matter of practical consequences.

2. "Abusive" Acts or Practices

Consumer protection laws long have prohibited "unfair or deceptive" practices—and those terms have a settled meaning as a result of the Federal Trade Commission's policy statements on "Deception" and "Unfairness" —which themselves rest on and incorporate decades of enforcement decisions and other litigation.[12]

The Dodd-Frank Act, however, goes further, empowering CFPB to prevent a person subject to the Bureau's jurisdiction "from committing or engaging in an unfair, deceptive, *or abusive* act or practice"; unfortunately the statute's ambiguous limiting language provides no practical guidance for a business trying to determine whether particular conduct is lawful.[13]

The "guidance" issued so far by CFPB on the meaning of "abusive" simply recites the statutory language.[14] It does not provide regulated businesses with the clarity available from the FTC policy statements and prior decisions interpreting "unfair" and "deceptive," or even give examples of the types of practices that would be considered abusive but are not otherwise unfair or deceptive. For three years, the Chamber has sought to obtain at least some clarity regarding the scope of the prohibition on abusive acts or practices—out of concern that this prohibition itself

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[12] *See* FTC Policy Statement on Deception (Oct. 14, 1983), *appended to* Cliffdale Associates, Inc., 103 F.T.C. 110, 174 (1984), *available at* http://www.ftc.gov/bcp/policystmt/ad-decept.htm; FTC Policy Statement on Unfairness (Dec. 17, 1980), *appended to* International Harvester Co., 104 F.T.C. 949, 1070 (1984), *available at* http://www.ftc.gov/bcp/policystmt/ad-unfair.htm.

[13] Pub. L. No. 111-203, § 1031(a) (2010), codified at 12 U.S.C. § 5531.

[14] *See* 12 U.S.C. § 5531(d); *CFPB Supervision and Examination Manual*, Part II.C (Oct. 2012), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf; CFPB Bulletin 2013-07, Prohibition of Unfair, Deceptive, or Abusive Acts or Practices in the Collection of Consumer Debts (July 10, 2013), *available at* http://files.consumerfinance.gov/f/201307-_cfpb_bulletin_unfair-deceptive -abusive-practices.pdf.

would be abused to create a vague and potentially very expansive form of liability. The Bureau's recent enforcement actions confirm those fears.

On May 30, 2013, CFPB initiated an action against American Debt Settlement Solutions, Inc. (ADSS). The resulting consent order stated that ADSS's actions were "abusive" in violation of Dodd-Frank because ADSS "knowingly enrolled in its debt-relief programs consumers whose financial conditions make it highly unlikely that they can complete the programs, and ADSS has nonetheless collected fees from consumers who had inadequate income to complete their debt-settlement program."[15]

The conduct described in the consent order was obviously wrongful, and found to be unfair and deceptive. But CFPB nonetheless chose to use an enforcement action in which the "abusive" claim was unnecessary and would go uncontested to begin to establish precedent regarding the meaning of "abusive." Thus, the "abusive" finding in the consent decree was not based on a determination that ADSS acted with wrongful intent—even though the rest of the findings make clear that ADSS did in fact have actual knowledge that the consumers could not complete the program—but rather appears to hinge only on the fact that the company had information indicating that consumers could not complete the program, whether or not the company had actually analyzed those consumers' ability to complete the program. The Bureau, in other words, has at least indicated that "abusive" conduct can be established by simple negligence in offering a product or service to any consumer if information available to the company would show that the product is not suitable for the consumer, even if the company has not undertaken that analysis. But again, the Bureau has espoused that standard indirectly, only by implication.

That leaves companies without any certainty regarding the legal test and, importantly, enables CFPB merely to imply this broad liability standard and therefore avoid responsibility for the adverse consequences that would flow from such a standard, such as the significant reduction in the availability of consumer credit if companies had to shoulder the expense of analyzing each consumer's suitability for every consumer financial product or service before offering the product or service to the consumer. Indeed, the Bureau does not appear to have assessed the consequences of its apparent interpretation or requested public comment on the issue, even though Congress considered the issue and specifically refused to enact suitability-type requirements included in early versions of the Dodd-Frank Act.

CFPB also included an "abusive" allegation in a subsequent enforcement action against Cash Call, Inc., a company that services and collects on consumer installment

[15] *CFPB v. American Debt Settlement Solutions, Inc., et al.*, No. 9:13-cv-80548-DMM, at 7-8 (S.D. Fla., June 7, 2013).

loans.[16] In addition to both an unfairness and a deception claim, the Bureau alleged that Cash Call had engaged in an abusive act or practice by collecting on loans that, according to the Bureau, were void under state law. This allegation raises the question what other violations of state law might, in the Bureau's view, amount to "abusive" acts or practices for the purposes of federal law, even if the company was unaware of the purported state law violation. This litigation will not answer that broad question—and will leave the legal standard uncertain.

Given these two CFPB enforcement actions, what should a regulated business do if it wants to comply with the law? Implement a compliance system based on the broadest possible interpretation of the Bureau's view—even if that will have adverse consequences for credit availability—or implement a system based on a narrower view (such as requiring intentional wrongdoing) and risk the possibility that the Bureau will subsequently interpret the provision more broadly? The Bureau could answer these broad questions—and assess whether its current approach would in fact have adverse consequences for consumers—even if it does not now wish to adopt a definitive construction of the term "abusive."[17]

By leaving these critical questions unanswered, CFPB risks real consumer harm. The Bureau's authority to prohibit "abusive" practices extends over every consumer credit transaction within its jurisdiction. Every market participant now must determine whether it can offer low-cost and innovative credit products without the risk of future second-guessing by the Bureau. This legal uncertainty inevitably will increase consumers' costs, reduce product offerings, and restrict credit availability.

3. Liability for the Acts of Service Providers

Similarly, CFPB has created unnecessary ambiguity regarding the scope of a financial service company's liability for the actions of a service provider. The Bureau has authority to issue rules covering service providers, to supervise those providers, and to bring enforcement actions against them.[18] Congress thus clearly intended the Bureau to be able to hold service providers accountable for any unlawful practices. In contrast, the Dodd-Frank Act does not specify a basis for holding a company liable for the unlawful acts of its service provider.

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[16] *See* Complaint, *Consumer Financial Protection Bureau v. Cash Call, Inc.*, No: 1:13-cv-13167-MBB (D.Mass. Dec. 16, 2013).

[17] A public process also would allow the Bureau to explain how its interpretation of abusive acts or practices does not contradict the Dodd-Frank Act's bar on the imposition of interest rate caps. *See* 12 U.S.C. § 5517(o).

[18] *See* 12 U.S.C. §§ 5514(e), 5515(d) (providing supervisory authority over service providers); 12 U.S.C. § 5531(a) (providing enforcement authority over service providers); 12 U.S.C. § 5531(b) (providing authority to prescribe rules applicable to service providers regarding unfair, deceptive, or abusive acts or practices).

The absence of statutory guidance on this significant question argues strongly for CFPB to undertake a rulemaking—or at least issue clear guidance—before imposing liability on a business for the unlawful acts of service providers. The Bureau clearly has the authority to consider a matter so "necessary or appropriate" to the administration of the Federal consumer financial laws.[19]

The only guidance provided by CFPB on this topic came in the form of a bulletin in April 2012. That document makes clear that the Bureau intends to hold companies accountable for failings by their service providers. It does not, however, provide any meaningful explanation of the scope or basis for that liability, or give companies concrete guidance on how to build risk-management regimes. Instead, CFPB states that business arrangements with service providers must not present "unwarranted risks to consumers," that companies must conduct "thorough due diligence" and "appropriate training and oversight," and that companies are obligated to take "prompt action to address fully any problems identified through the monitoring process, including terminating the relationship where appropriate."[20]

The far more detailed guidance issued on the very same topic by the Federal Reserve and the Office of the Comptroller of the Currency[21] makes clear CFPB could do much more to help financial service providers manage risk and comply with the law.

Even in the absence of meaningful guidance to companies, CFPB has enforced standards it has never clearly articulated. A recent enforcement action against GE Capital Retail Bank and CareCredit LLC alleged that consumers were injured when service providers—generally doctors' and dentists' offices—inadequately explained the terms of a deferred interest promotion. The resulting consent order effectively treated these alleged violations of the Dodd-Frank Act as if they were committed directly by the companies themselves. To remedy these alleged violations, the Bureau imposed a monetary fine and a series of specific controls over the service provider relationships going forward.

Again, a law-abiding business would not know whether the terms of the consent order reflect generally applicable standards that CFPB believes other financial institutions should follow. And the Bureau's decision not to obtain public comment

[19] *See* 12 U.S.C. § 5512(b)(1).
[20] CFPB Bulletin 2012-03, Service Providers at 2-3 (April 13, 2012), *available at* http://consumerfinance.gov/f/201204_cfpb_bulletin_service_providers.pdf.
[21] *See* Board of Governors of the Federal Reserve System, *Guidance on Managing Outsourcing Risk* (Dec. 5, 2013), *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf; Office of the Comptroller of the Currency, OCC Bulletin 2013-29, *Third Party Relationships* (Oct. 30, 2013), *available at* http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.

means it cannot predict the consequences of applying such a rule broadly—for example, that costs to consumers would increase because financial institutions would be forced to duplicate the service provider's own compliance system and that financial institutions will be incentivized to use only very large service providers, because they have the financial means to impose sophisticated compliance regimes and to indemnify the financial institution against any consequences of a compliance failure.

The Bureau has responsibilities to protect consumers and ensure well-functioning credit markets and must be careful to explore the effects of contemplated actions on consumers and the credit markets as it works to make informed, balanced decisions. The notice-and-comment rulemaking process is designed to help the agency do just that.

4. "Best Practices" as Implied Regulation

On February 10, 2014, Director Cordray wrote to the Chief Executive Officers of a number of the largest credit card companies to "strongly urge" those companies to provide free credit scores to their customers on their monthly statements.[22]

The stated goal of this effort was to change consumer behavior. The problem, in the Bureau's judgment, was that American consumers "fail to see the importance of their credit standing even if it has affected them in material ways, such as being rejected for a job or charged a higher price for a loan," and that, even now, "fewer than one in five Americans checks his or her credit report in a given year through either free or paid channels."[23] Disapproving of this consumer behavior, the Bureau was interested in "get[ting] more Americans to pay closer attention to their credit standing," and it was up to the credit card companies to "help us achieve this goal."[24] To that end, Cordray wrote:

> I strongly encourage you to make the credit scores on which you rely available to your customers regularly and freely, along with educational content to help them make use of this information. We will consider this to be a "best practice" in the industry. Doing so through existing channels, such as including credit scores with other on-line account information and on monthly statements, is likely to yield positive returns that outweigh the limited effort involved. Customers who monitor and

[22] Anonymized Letter to CEO of Credit Card Companies (Feb. 10, 2014), *available at* http://files.consumerfinance.gov/f/201402_cfpb_letters_credit-scores.pdf.
[23] *Id.*
[24] *Id.*

manage their credit standing may be less likely to become delinquent or to default.[25]

This de facto directive to credit companies raises a number of technical compliance questions for credit card companies, as well as a broader set of policy issues that call into question the fairness of CFPB's approach to shifting customer and industry behavior. Compliance questions include:

- What score should the credit card company provide to the user? A FICO score from one of the three credit rating agencies, even if that score is not the one the company actually relies on to determine credit-worthiness? The score that the company actually uses to determine credit-worthiness, even if it is on a different scale from the FICO score, is proprietary, and is not readily understandable by consumers?

- Should all credit card companies provide the same scores to consumers? Do companies face a risk of allegations of collusive, anti-competitive behavior if they all decide to provide consumers with the same score?

- Will a company that provides a consumer a FICO score that is not actually used to determine credit-worthiness, or a proprietary score that cannot be easily explained to consumers without revealing trade secrets, be exposed to a charge of "deception" under 12 U.S.C. § 5531(a)?

- What are the legal ramifications of the failure to adopt a "best practice" identified by the Bureau? Will failure to do so affect the supervisory process or color enforcement decisions? What are the reasons that the Bureau will accept for a business concluding that it is impractical, legally risky, or imprudent from a business perspective to adopt a "best practice"?

More broadly, CFPB's attempt to use the announcement of "best practices" to shift industry and even consumer behavior raises substantial legal and policy questions for the Bureau going forward. These questions include:

- Which statutory provision authorizes the CFPB to try to alter consumer behavior by imposing de facto standards on industry through the announcement of a "best practice"? Is the establishment of a "best practice" the issuance of "guidance implementing Federal consumer financial law," *see, e.g.,* 12 U.S.C. § 5511(c) (5)? Or does the Bureau consider

[25] *Id.*

efforts to shape consumer behavior to be an element of its "financial education programs," *see, e.g.*, 12 U.S.C. § 5511(c) (1)?

- Does the issuance of "best practices" without any clear basis in binding legal requirements conflict with the Bureau's statutory purpose of implementing and enforcing Federal consumer financial laws "consistently," *see, e.g.*, 12 U.S.C. § 5511(a)?

- Does informally pushing all market participants to adopt identified "best practices" support or stifle competition in the marketplace, *see generally* 12 U.S.C. § 5511(a)?

- Does the de facto imposition of "best practices" conflict with the Bureau's responsibility to avoid unnecessary regulatory burdens, *see, e.g.*, 12 U.S.C. § 5511(b) (3)?

- Assuming that adoption of identified "best practices" is in fact truly discretionary and not required by the laws that the Bureau has responsibility to implement, what expertise does the Bureau have regarding how companies should make discretionary decisions about how to run their businesses?

- Assuming the issuance of "best practices" is legally proper, what regulatory process should be used to ensure that they are evidence-based and reflect a considered-judgment based on a full understanding of the costs and benefits to consumers and other stakeholders? Should any "best practice" be issued without an opportunity for consumers and industry stakeholders to provide comment and expertise?

CFPB should consider these questions before it issues further "best practices" in an effort to shape consumer behavior and the financial services market more broadly. We particularly emphasize that the Bureau should not use the supervision process to subject company behavior to extralegal standards. The Chamber has been told this is becoming an increasingly common practice among Bureau examination teams, and is extremely concerned about the inevitably inconsistent application of federal law that this will cause. The Chamber strongly believes that it is the role of financial regulators to identify and enforce clear rules of the road, and then to leave the private market to compete within those rules. Informal "best practices" threaten this basic principle.

5. Short-Term Lending

Despite CFPB's reluctance to write rules in other areas, the Bureau made clear that it will begin a comprehensive rulemaking process to address short-term lending. As recently as March 25, Director Cordray explained that the Bureau is in the "late stages" of developing these rules. But even as CFPB gears up to engage in a public discussion about the costs and benefits of regulatory changes in these markets for businesses and consumers, the Department of Justice (DOJ)—apparently in coordination with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and other agencies—has worked behind the scenes to cut off the short-term lending market from the banking and payment system., and the FDIC and OCC have separately used supervisory guidance to dissuade banks from offering their own, lawful short-tem lending products.

The stated purpose of the enforcement effort is to combat consumer fraud, a goal shared by the Chamber and the members of the financial services industry, and the stated goal of the supervisory effort is to reduce risks to institutions. However, the apparent unspoken goal of the overall effort, and certainly the practical effect, is to fundamentally reshape or eliminate the third-party payment processor and short-term lending markets. Here, once again, ambiguous legal standards are having the effect of lumping in legal products and services with fraudulent activity, disrupting the banking system, and threatening to reduce the availability of consumer credit.

These efforts raise important questions about the proper role of bank regulators in deciding whether entire product categories—in this case third-party payment processing and short-term lending products—are disfavored and thus subject to elimination through legal action or unsupported supervisory guidance. Although the Department of Justice acknowledges that such businesses are not "*per se* fraudulent,"[26] their actions betray deep suspicion of entire business models. In fact, the Justice Department generally categorizes such businesses, even lawful, licensed, highly regulated, and in some cases directly federally supervised, as "high-risk merchants," and provides no clear vision of a role for them in the future of the financial services industry.

But if the goal or anticipated effect is to eliminate risk by reshaping entire product categories—and the many legitimate businesses they contain—surely the proper approach should be a rulemaking based on clear jurisdiction, a full record, and deliberate consideration of the possible harms to consumers associated with the elimination of financial services on which they rely to make ends meet. Federal

[26] *Id.* ¶ 29 & n.1.

regulators and enforcement agencies should articulate specific and clear standards for financial institutions. Regulators then should use their authorities to prevent conduct that violates such standards, not as a means to attack business practices that they otherwise have chosen not to regulate or pursue through direct enforcement.

B. Impeding Capital Formation

In drafting and implementing regulations, the various banking regulators have ignored processes mandated by law. This failure has led to adverse economic ramifications as witnessed by the impact of the Volcker Rule upon trust preferred bonds and collateralized loan obligations. Regulators have also failed to abide by specific limitations imposed by Congress and when Regulators have been given latitude in action, they have not exercised discretion when a rational examination of events call for it to be used to prevent potential instability in the financial system. Listed below are some representative, though not exhaustive, examples of these concerns.

1. Failure to Follow Legally Required Economic Analysis in Rulemaking

The banking regulators have not provided a cost benefit analysis when drafting or finalizing regulations even though they are required to do so by law. This failure to conduct a cost benefit analysis when writing rules is inconsistent with the obligations of the Federal Reserve, FDIC, and OCC under the Riegle Community Development and Regulatory Improvement Act ("Riegle Act", 12 U.S.C. §4802(a)). This law applies to all "Federal banking agencies" defined by cross-reference in Section 4801 of the Riegle Act (12 U.S.C. §1813) to include the OCC, FDIC, and Federal Reserve.

The Riegle Act mandates that "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."[27]

Such a Riegle Act analysis was not provided for the Volcker Rule or other regulations that have been completed. While OCC did conduct an economic analysis for the Volcker Rule, it was published in the Federal Register almost one month after

[27] 12 U.S.C. §4802(a) (emphasis added).

the final rule had been published. This analysis was conducted under the Unfunded Mandates Reform Act (UMRA) and was not an exhaustive analysis as required under either UMRA or the Riegle Act.

The Chamber has recently written to the banking regulators expressing concerns that proposed regulations such as risk retention, leverage coverage ratio rule and incentive compensation fail to contain Riegle Act analyses

2. Failure to Abide by Statutory Limits Passed by Congress

Senators Pryor and Vitter successfully included a bipartisan amendment in the Dodd-Frank Wall Street Reform and Consumer Protection Act designed to specifically limit the number of non-bank companies that may be considered for potential systemic risk regulation.

The Pryor-Vitter amendment, contained in section 102(b) of the Act, gave the Federal Reserve the authority to "establish by regulation, the requirements for determining if a company is predominantly engaged in financial activities, *as defined in subsection (a) (6)*," which refers to "activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956)." The Dodd-Frank Act did not give the Federal Reserve the authority to establish criteria for determining if a company is predominantly engaged in financial activities of the same general type as those set forth in section 4(k). Nor did it authorize the Federal Reserve to establish by regulation the requirements for determining whether a company is predominantly engaged in financial activities as the Federal Reserve may choose to define that term. It said "as defined in section 4(k)" without limitation, qualification, or any other reservation that permits the Federal Reserve to create a list of activities that are financial in nature for nonbanks that differs in any way from the activities banks are authorized to conduct consistent with section 4(k) and Regulation Y.

Accordingly, by law, the Federal Reserve and Financial Stability Oversight Council (FSOC) can only consider specific banking activities by non-bank financial companies, which then in turn must meet specific threshold criteria, in selecting non-bank financial companies for consideration as a potential systemically important financial institution (SIFI). However, in its regulations implementing the predominantly engaged test, the Federal Reserve broadened the scope of activities that may be considered for non-bank companies.

This contravenes the Congressional intent by increasing the number of businesses that may be considered for SIFI designation which the Pryor-Vitter amendment expressly sought to limit. This was best exemplified by the Office of

Financial Research's (OFR) asset manager study that was openly acknowledged to be the first step in asset management. This interesting to note since certain forms of asset management, such as the operation of mutual funds, do not fall within the prescribed definition of banking activities. Besides the technical issues this raises, it calls into questions the understanding of the regulators regarding the limits of their authority.

3. The Collins Amendment

The Collins Amendment (Section 171 of the Dodd-Frank Act) requires banking regulators to impose leverage and risk based capital standards for depository institutions, bank holding companies, foreign bank organizations, thrifts and non-bank financial companies designated as SIFIs. Even though the drafters of the Collins Amendment have stated that Section 171 gives banking regulators discretion in the development of capital standards, the banking regulators disagree and have imposed bank style capital upon non-bank financial companies.

This is currently being played out with insurance companies that have been designated as SIFIs. By not exercising discretion, banking regulators fail to take into account the different business models that exist within the non-bank world and the insurance industry specifically. This has the potential to cause regulatory mismatches that may conflict with insurance regulations that have been developed for well over 150 years. Regulatory conflicts of this nature will increase risk within the industry rather than temper it. Even with two firms being so designated, the additional bank-centric type regulation will cause ripples throughout the industry that will have negative consequences for the industry's business model.

Banking capital rules do not fit with non-bank companies and will hamper the ability of those firms to meet the needs of their customers, as well as their ability, when it comes to the insurance industry, fulfill its traditional role as the largest long-term investor in the economy. This will have collateral negative impacts for the rest of the economy.

4. Lack of Coordination

The banking regulators have also failed to coordinate with their international counterparts to have consistent rules on capital standards.

International uniform capital rules are only homogeneous if their interpretation, application and enforcement are the same across the board. As an example, differences among national regulators as to the quality of capital that must be held to satisfy Basel III requirements will in fact mean that there is no global uniform set of

capital rules. Mechanisms are needed so the interpretation and application of the Basel III rules are the same and followed across the board. Failure to do so will create regulatory capital arbitrage and gaps in the overall financial regulatory architecture.

U.S. banking regulators have been drafting rules to implement Basel III capital standards at the same time international regulators raised concerns that the Basel III capital framework is too complex. Part of the concern is that complexity may cause opaqueness, frustrating the goal of safety and soundness by hampering the ability of regulators and investors to understand the health of individual banks or to compare the soundness of different banks. Rather than provide a clear window into the well-being of financial institutions, Basel III in its current form is creating a kaleidoscope of images. As a result, the Basel Committee on Banking Supervision released for public comment and is contemplating the Basel III capital simplification study to achieve a better understanding of the complexity of capital requirements and how to simplify them to better achieve stability in financial institutions.

This is but one example of regulators, domestic and international, going in opposite directions. Such divergence is not conducive for efficient capital markets in a global economy.

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The Chamber appreciates the Committee's continued attention to the importance of clear, well-reasoned, economically sound, well-coordinated standards for the banking and financial services industry. We look forward to working with the Committee as it continues to support capital and consumer credit markets that are fair and competitive, and that benefit all Americans.

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

February 25, 2014

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Legislative & Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

Regulations Division
Office of the General Counsel
Department of Housing and Urban Development
451 7th Street, SW
Washington, DC 20410

Re: Joint Proposed Rule on Credit Risk Retention OCC RIN 1557-AD40; FRB RIN 7100-AD70; FDIC RIN 3064-AD74; SEC RIN 3235-AK96; FHFA RIN 2590-AA431 HUD RIN 2501-AD53

Dear Mr. deV. Frierson, Mr. Pollard, Mr. Feldman, Ms. Murphy, and To Whom It May Concern:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing over three million companies of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and efficient regulatory structure for capital markets to fully function in the 21st Century economy.

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Mr. Alfred M. Pollard
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Ms. Elizabeth M. Murphy
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The CCMC previously submitted comments on *Joint Proposed Rule on Credit Risk Retention* ("proposed risk retention rules") as proposed by the Board of Governors of the Federal Reserve ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), the Office of the Comptroller of the Currency ("OCC"), the Department of Housing and Urban Development ("HUD") and the Federal Housing Finance Agency ("FHFA") (also collectively "the regulators").[1]

Along with our many substantive concerns, the CCMC comments on the proposed risk retention rules expressed concern about the process associated with these proposals. Specifically, we noted that the proposed risk retention rules could have wide ranging economic impacts and that the proposals failed to provide a cost-benefit analysis. Without a cost-benefit analysis, the proposed risk retention rules do not allow commenters to understand the economic impacts of the rules and standards under consideration. These procedural irregularities impaired the ability of commenters to provide the regulators with informed comments on the proposed risk retention rules. We write today to further explain these procedural concerns associated with the absence of a cost-benefit analysis in these proposed rules.

The absence of cost-benefit analysis for the proposed risk retention rules is inconsistent with the obligations of the Federal Reserve, FDIC, and OCC under the Riegle Community Development and Regulatory Improvement Act (Riegle Act, 12 U.S.C. §4802(a)). This law applies to all "Federal banking agencies" defined by cross-reference in Section 4801 of the Riegle Act (12 U.S.C. §1813) to include the OCC, FDIC, and Federal Reserve. The Riegle Act mandates that "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations." [2]

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[1] *See* CCMC and coalition comment letters of August 2, 2011, September 26, 2013 and October 28, 2013.
[2] 12 U.S.C. §4802(a) (emphasis added).

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The Federal banking agencies covered by the Riegle Act must meet these commitments whether or not they are raised by commenters in the course of a rulemaking because they are statutory requirements for their exercise of rulemaking authority by the relevant agencies that impose "additional reporting, disclosure, or other requirements on insured depository institutions." There can be no question that the proposed risk retention rules impose such additional obligations on insured depository institutions for purposes of the Riegle Act. As an organization representing both depository institutions and their customers, the CCMC has an interest in ensuring that regulators honor their obligations under the Riegle Act. We note that these requirements also apply to many of other regulations associated with implementation of the Dodd-Frank Act by the Federal Reserve and other Federal banking agencies, and not just the proposed rule cited in this letter. To date, however, we have not seen the required cost-benefit analysis for the proposed risk retention rules.

We welcome the opportunity to discuss the cost-benefit analysis obligations of the Federal Reserve and other Federal banking agencies under the Riegle Act in relation to the proposed risk retention rules and other pending and recently completed rulemakings by Federal banking agencies.

Sincerely,

Tom Quaadman

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

September 23, 2013

Mr. Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Legislative and Regulatory Affairs Division
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: **Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions; 12 CFR Part 6, Docket ID OCC-2013-0008; RIN 1557-AD69; 12 CFR Parts 208 and 217, Regulation H and Q, Docket No. R-1460, RIN 7100-AD; 12 CFR Part 324, RIN 3064-AE01**

Dear Messrs. Frierson, Feldman, and To Whom It May Concern:

The U.S. Chamber of Commerce ("the Chamber"), the world's largest business federation represents the interest of more than three million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for the capital markets to fully function in a 21st century economy. The Chamber appreciates the opportunity to comment on *Regulatory Capital Rules:*

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Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions ("proposed leverage ratio rules") as proposed by the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (also collectively known as the "regulators"). [1]

The CCMC is concerned that the proposed leverage ratio rules are premature. The Bank for International Settlements ("BIS") has issued for comment a discussion paper on *The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability* ("Basel III capital simplification paper") in an effort to reduce the complexity and opaqueness of the Basel III capital agreements (Basel III"). Furthermore, the Federal Reserve has not yet completed the final promulgation of the rules implementing section 165 of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The proposed leverage ratios are also creating a divergence from international standards. The Chamber also wishes to express concerns that the proposed leverage ratio rules may adversely impact the ability of businesses to attract capital harming their ability to grow and create jobs.[2]

Accordingly, the CCMC recommends that consideration of the proposed leverage ratio rules be suspended pending the review and finalization of regulatory initiatives based on the Basel III capital simplification paper and the final promulgation of the rules implementing section 165 prudential standards.

Discussion

The CCMC believes that capital, liquidity and leverage requirements are important tools to achieve and maintain stability within financial institutions. However, capital standards and leverage ratios that are too arduous can have serious,

[1] *See* also letter of September 19, 2013 from the Chamber to the Basel Committee on Banking Supervision commenting on *Revised Basel III leverage ratio framework and disclosure requirements* ("Proposed Leverage Ratio Framework").
[2] *See* also letter of June 14, 2011 from the Chamber to Federal Reserve Chairman Ben Bernanke on GSIFI surcharges and the letter of October 22, 2012 from the Chamber to the regulators commenting on the proposed Basel III implementing regulations.

unintended negative consequences. Allowing suitable levels of risk-taking and providing access to liquid capital markets are necessary elements needed to fuel business growth, job creation, and innovation throughout the domestic and global economy. Providing access to liquid capital markets must be balanced with the need to establish appropriate safeguards to maintain the overall safety and soundness of the financial system. An integrated regulatory framework, implemented consistently across jurisdictions, is necessary to provide uniform incentives and disincentives to mitigate potential systemic risks to safety and soundness.

The proposed Leverage Ratio Rules are buttressed upon the triple pillars of the International Lending Supervision Act ("ILSA"), section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and Basel III. The ILSA encourages regulators to work with their international counterparts to establish consistent supervisory policies and practices including the establishment of minimum capital requirements. Section 165 of the Dodd-Frank Act requires the Federal Reserve to impose prudential standards on large bank holding companies and non-bank financial companies that have been designated as being systemically important. Basel III seeks to impose minimum capital requirements, leverage ratios, and liquidity requirements for banks that operate internationally.

a. Basel III Complexity and Simplification

Recently, regulators have joined investors and other commentators in raising concerns that the Basel III capital framework is too complex. Part of the concern is that complexity may cause opaqueness, frustrating the goal of safety and soundness by hampering the ability of regulators and investors to understand the health of individual banks or to compare the soundness of different banks. As a result, the Basel Committee on Banking Supervision released the Basel III capital simplification paper to achieve a better understanding of the complexity of capital requirements and how to simplify them to better achieve stability in financial institutions. The comment period for the Basel III capital simplification paper ends on October 11, 2013.

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Basel III is the foundation for the system of capital requirements, leverage ratios and liquidity requirements that global regulators have been building upon since the 2008 financial crisis. The regulators have moved forward in building such a system here in the United States, and in fact, have moved in an aggressive manner to put in place tougher requirements than the majority of other nations. While tough capital rules may be called for, though balanced with other considerations raised later in this letter, we must question further movement along these lines as the foundation for this system has been called into question.

Furthermore, the ILSA seeks to create consistent international standards. The G-20 has clearly made consistent capital requirements a priority to be addressed in the wake of the financial crisis. While we understand that the depth and structure of markets may require different level of responses, we are concerned that the proposed leverage ratio rules are creating a wide divergence from a consistent international framework that frustrates the intent of the ILSA.[3]

b. Section 165 Prudential Standards

Section 165 of the Dodd-Frank Act authorizes the development and use of prudential standards to regulate the potential systemic risk of banks and non-bank financial companies that have been designated as being systemically important. Enhanced capital standards, leverage ratios and liquidity requirements are among the tools that the Federal Reserve may use to carry out section 165.

The Comment period for the Section 165 prudential standards closed on April 30, 2012, and to date the final rules have not been finalized and promulgated.[4] The section 165 rules will be the central means of regulating systemic risk for systemically important firms. It would be prudent for these enhanced tools to be fully fashioned before developing higher leverage ratios that go beyond the minimums as set by international agreement.

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[3] *See* October 22, 2012 letter from Chamber commenting on regulations implementing Basel III capital standards and need for international consistency.
[4] *See* letters of January 30, 2012 and April 30, 2012 from the Chamber to the Federal Reserve commenting on the proposed Section 165 prudential standards rules.

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c. Inconsistent Regulation Across Jurisdictions

While Basel III attempts to create a uniform international system of capital requirements, we note with significant concern the increasing number of differences arising in regulatory reforms across major jurisdictions. For example, the proposed leverage ratio rules, issued by the regulators to increase the existing minimum leverage ratio requirement for certain large U.S. bank holding companies and their insured depository institutions, as compared to the BCBS' proposed leverage ratio framework, results in significant differences in the minimum capital requirements across product types. Such inconsistencies may introduce competitive disparities, operational and enforcement uncertainties and systemic inefficiencies, all of which could lead to greater systemic risks, adversely impact economic growth and impede cross-border capital flows needed for businesses to operate on a global basis.

Basel III can only be a homogenous standard if its interpretation, application and enforcement are the same across the board. Greater effort is required to minimize the further fragmentation and inconsistencies arising across jurisdictions in capital, liquidity and leverage frameworks, as well as other regulatory reform initiatives such as resolution authority and derivative regulations. We encourage the regulators to pursue coordination efforts with the BCBS and other appropriate parties to achieve consistent implementation of a uniform regulatory framework. The CCMC also believes the regulatory reforms related to capital, liquidity and leverage require further evaluation for internal consistency.

Furthermore, the ILSA encourages regulators to work with their international counterparts to establish consistent supervisory policies and practices including the establishment of minimum capital requirements. The G-20 has clearly made consistent capital requirements a priority to be addressed in the wake of the financial crisis. While we understand that the depth and structure of markets may require different levels of response, we are concerned that the Proposed Leverage Ratio

Framework creates greater inconsistencies within the international framework that frustrates the intent of the ILSA.[5]

An integrated regulatory framework, implemented consistently across jurisdictions, is necessary to provide uniform incentives and disincentives to mitigate potential systemic risks to the safety and soundness of the financial system.

d. Capital Formation Concerns and Potential Economic Impacts

The proposed leverage ratio rules are the latest in a series of initiatives that may hamper the ability of businesses to access the capital and liquidity needed to grow and operate.

A comprehensive review of these initiatives would illustrate:

- The proposed leverage ratio rules, as applied to major U.S. insured depository institutions, are twice the requirement in Basel III;
- Capital surcharges upon Global Systemically Important Financial Institutions ("GSFIs")will force large internationally active banks to withdraw additional capital from productive capital formation streams;
- The Volcker Rule will impact the ability of non-financial businesses to enter the debt and equity markets by raising costs and creating barriers to entry ;
- Proposed Money Market Fund reform may harm the ability of non-financial businesses to access the short-term commercial paper markets and manage cash;

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[5] *See* October 22, 2012 letter from Chamber commenting on regulations implementing Basel III capital standards and need for international consistency.

- If the Volcker Rule and Money Market reform hamper capital formation, the next alternatives are commercial lines of credit; however, Basel III creates disincentives for banks to provide businesses with commercial lines of credit; and

- Other Dodd-Frank Act provisions including derivatives regulation will impact the ability of non-financial companies to mitigate risk.

The combination of all of these initiatives could lead to an underperforming financial sector, create barriers to capital formation and have unintended ramifications throughout the rest of the economy. The inability of businesses to be able to engage in normal capital formation activities, efficient cash management and effective risk management will raise costs and create inefficiencies adversely impacting economic growth.

Conclusion

The Chamber believes that a balanced approach to capital requirements and leverage ratios are a pro-growth means of addressing over-leveraging and providing stability in a risk-based free enterprise system. However, the Chamber is very concerned that the foundation upon which the proposed leverage ratio rules has been built is being questioned by the BIS as too complex and in need of simplification. Accordingly, the Chamber believes that the regulators should suspend consideration of the proposed leverage ratio rules pending the review and completion of regulatory initiatives based on the Basel III simplification paper. Similarly, we believe that the use of leverage ratios as a tool to be used in systemic risk regulation calls for a similar suspension of consideration of the proposed leverage ratio rules pending the completion of the Section 165 rulemaking.

Furthermore, a carefully calibrated system balanced between stability and appropriate risk taking is necessary for the stability of financial institutions and the ability of businesses to access capital in order to grow and create jobs. A doubling of

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the leverage ratios, as compared to the Basel III requirements may, in our view, be disruptive to that balance harming economic growth and job creation.

Thank you again for the opportunity to comment upon the proposed leverage ratio rules, and we are happy to discuss these issues and concerns in greater detail at your convenience.

Sincerely,

Tom Quaadman

United States Senate

WASHINGTON, DC 20510

May 16, 2012

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Dear Mr. Chairman:

On April 2nd the Board of Governors requested comment on a proposed amendment to the Board's Notice of Proposed Rulemaking (NPR) issued February 11, 2011, to establish requirements for determining whether a company is "predominantly engaged in financial activities." We believe that your proposed rule attempts to circumvent our amendment and we urge you and the Board to reconsider the rule.

As you are aware under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a company can be designated for Board supervision by the Financial Stability Oversight Council if 85 percent or more of the company's revenues or assets are related to activities that are financial in nature under the Bank Holding Company Act. The requirement that a company be "predominantly engaged in financial activities" before it may be subject to bank-like regulation was the result of an amendment we offered during Senate consideration of legislation which ultimately became Dodd-Frank. You will recall that prior to this amendment the legislation gave financial regulators authority to regulate nonbank financial companies based on less precise criteria, such as whether the company is "in whole or in part, directly or indirectly, engaged in financial activities," (House version) or "substantially engaged in financial activities," (the Senate version), in the latter case as defined by the Federal Reserve.

Because of our shared concern that the original House or Senate language was too vague, and could potentially open many commercial enterprises to inappropriate bank-style regulation, the amendment we offered tied the definition back to the familiar standard of "predominantly engaged" as defined in section 4(k) of the Bank Holding Company Act. It was our belief that this definition of "financial activity" was well defined and properly circumspect, and that combined with the 85 percent predominance test would ensure that manufacturers, retailers and natural resources businesses would be able to operate free of the fear that they would be ensnared in regulations designed to address a financial crisis which they did not create, and indeed, of which they were in many cases the victim.

Unfortunately, despite the clarity provided in the overwhelming adoption by the Senate of our amendment, and the conference committee's defense of the amendment despite attempts to alter the amendment or remove it completely, the Board's latest proposed rulemaking once again potentially extends financial regulations to businesses that were clearly intended by Congress to be excluded by the law. Specifically the proposed rule would include as financial activity "Engaging as principal in...forward contracts, options,...and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset...nonfinancial asset, or group of assets."

In the text accompanying the release the Board notes that this broad expansion is beyond what is strictly provided under either section 4(k) or existing Regulation Y. Unfortunately the Board's proposed expansion is precisely the type of overreach that our amendment was intended to address. Under the proposed rule the Board has significantly deviated from the plain language of Dodd Frank, which provides in section 102(b) that "the Board of Governors shall establish, by regulation, the requirements for determining if a company is predominantly engaged in financial activities, as defined in subsection (a)(6)." As the Board is aware, (a)(6) of Section 101 of Dodd Frank clearly states that the predominance test applies with respect to assets and revenues derived "from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Act of 1956)…" Section 102(b) does not state that the Federal Reserve is to define "financial activities" for purposes of Dodd Frank. Instead it directs the Board to establish the requirements "for determining if a company is engaged in financial activities" as defined in the Bank Holding Company Act.

The inclusion of forwards and options in determining whether a company is "predominantly engaged in financial activities" is contrary to both the spirit and plain language of Dodd Frank. In order to ensure that commercial enterprises are not dragged into inappropriate financial regulatory schemes, and to provide certainty to businesses that seek to expand and create jobs, we request that you amend the proposed rule by deleting the reference to forwards and options, or, at a minimum, clarifying that forwards and options which are intended to be physically settled are not included in the list of financial transactions included in paragraph 13(ii)(B) and (C) of the Appendix to Subpart N. Additionally we request that the Board clarify that under no circumstances should the transactions described in paragraph 13(ii) be considered "financial" with respect to a commercial manufacturer, producer, shipper, energy or commodity firm, or similar nonfinancial enterprise when they are incidental or ancillary to a party's activities as such.

Thank you and please do not hesitate to contact us with any questions.

Sincerely,

David Vitter
United States Senator

Mark Pryor
United States Senator

100 Years Standing Up for American Enterprise

U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

ON: "Implementing Title I of the Dodd-Frank Act: The New Regime for Regulating Systemically Important Nonbank Financial Institutions"

TO: The Subcommittee on Financial Institutions and Consumer Credit

DATE: May 16, 2012

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Capito, Ranking Member Maloney and members of the Financial Institutions and Consumer Credit Subcommittee, my name is Tom Quaadman. I am vice president for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents.

To compete, grow, and create jobs, America's businesses need efficient capital markets. Efficient capital markets allow businesses to have the access to the resources needed to operate on a daily basis and strategically plan for long-term success. Effective regulators who understand these markets create a regulatory regime that promotes balance and allows good actors to play on an even playing field while identifying and acting against bad actors through vigorous oversight and enforcement.

Monitoring and regulating systemic risk, whereby the collapse of a firm could imperil the entire domestic and/or global financial system, is an important part of a regulatory structure needed for America's businesses to compete in a 21st century economy. While systemic risk is a very broad subject, I will confine my remarks to the issues related to the subject of today's hearing—identifying and regulating nonbank companies that are engaged in financial activities to such a degree and on such a scale that they pose a systemic risk to U.S. and global financial markets..

1. Overview

In 2007, the Chamber created the Center for Capital Markets Competitiveness. The Center was established to advocate for financial regulatory reforms needed to ensure that American businesses had access to efficient flows of capital necessary to compete in a 21st century global economy.

It became apparent during the 2007-2008 financial crisis that the Federal Government did not have the regulatory apparatus necessary to identify, assess and, when appropriate, manage systemic risk. In November, 2008, the Chamber called for the establishment of a systemic risk regulator as part of a larger financial regulatory reform effort. Congress included systemic risk regulation in Title I and II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). While the Chamber opposed the final passage of the Dodd-Frank Act, the Chamber supported legislative efforts to properly address systemic risk. In particular we supported the efforts that resulted in the Pryor-Vitter amendment which creates the "predominantly engaged in financial activities" test for nonbank companies. We continue to believe that this amendment provided needed clarity to the process of identifying nonbank financial institutions that may be subject to designation for additional regulatory scrutiny as systemically important institutions.

In looking at means of managing systemic risk, Congress recognized that with respect to nonbank companies, it was crucial to provide a clear delineation between nonbank financial institutions, and those companies whose financial activities are incidental to a primary commercial focus.

We believe that Congress did a good job in striking that balance. However, we are very concerned that the implementation of Title I of the Dodd-Frank Act by regulators is being done in a manner that is manifestly contrary to the clear and unambiguous language Congress used to strike this important balance.

Congress clearly recognized that care must be exercised in distinguishing nonbank companies that may be systemically important from nonbank companies whose financial activities are ancillary to other commercial activities and have not posed such a threat. Thus, Congress established a two-part test for determining if nonbank companies should be considered to be financial companies, and potentially designated as systemically important. This process can be thought of as two inverted funnels sitting on top of each other.

Under Title I of the Dodd-Frank Act nonbank companies first have to pass through a narrow stem of exacting criteria established by the Pryor-Vitter amendment to determine if a company is a financial company—that is, a company that is predominantly engaged in financial activities. A company is considered to be predominantly engaged if 85% of its consolidated revenues or assets are derived from financial activities as defined in section 4k of the Bank Holding Company Act. Section 4k defines specific activities, that when conducted subject to specific conditions, are considered "financial in nature" such that a regulated bank may engage in them.

Those companies that meet this high threshold for being U.S. or foreign "nonbank financial companies" then pass through to the "second funnel." In part two, or the wide part of the second funnel, Financial Stability Oversight Council ("FSOC") determines if a U.S. or Foreign nonbank financial company should be designated as a systemically important financial institution ("SIFI") by using a broad set of criteria including leverage and off balance sheet exposures. Going through the narrow stem of the second funnel, once a company is designated, it is subject to enhanced prudential regulation and oversight by the Board of Governors of the Federal Reserve ("the Board"), though the SIFI's prudential regulator is given the lead role in shaping regulations to meet the unique needs of the company.

We believe that Congress struck the right equilibrium with this system. It ensures that only nonbank companies engaging on a considerable scale in financial activities permissible for a regulated bank to undertake are even candidates to be assessed for designation by the FSOC. Once this initial sifting has been completed, Congress further required that banks and nonbank financial companies labeled as SIFIs by the FSOC should be treated differently from one and other. This is why the Dodd-Frank Act acknowledges the need for nonbank SIFIs to have enhanced regulations that meet the parameters of their business model and are different from the enhanced regulations mandated for systemically important banks.

In short, Congress determined that the power to designate and regulate nonbank SIFIs should be used only sparingly and, if used, it must result in regulations that take into account the unique circumstances of each company and the markets in which it competes. This system allows for the assessment and regulation of threats to the system, without causing undue stress or harm to the economy.

Unfortunately, the Board and FSOC are disregarding the carefully balanced structure Congress passed into law. In doing so regulators are creating exactly the uncertainty and potential for regulatory overreach that prompted the Pryor-Vitter Amendment. If they are allowed to obtain by regulatory fiat a scope of power and discretion Congress denied them, regulators may create economic imbalances harming businesses and consequently economic growth and job creation.

Instead of the narrow "stem" of the first inverted funnel that limits inclusion to those nonbank businesses that meet the exacting "predominantly engaged" standard, the regulators are broadening the criteria to create a high-capacity pipeline. This flies in the face of both the intent and specific language of the Pryor-Vitter amendment. This may ensnare companies into the systemic risk web who should not be there. By broadening the range of activities counted towards whether nonbanks are threatened with being placed in the pot of entities that may be considered for nonbank SIFI designation by the FSOC, regulators are overreaching into commercial activities that had nothing to do with the recent financial crisis. In doing so, they do not lessen systemic risk. They simply compel responses that have adverse consequences throughout the economy.

The fear and uncertainty that this regulatory overreach imposes is further enhanced by the fact that, as will be discussed further, the Federal Reserve has not given prudential regulators the lead role in shaping specific regulations for specific nonbank businesses that are ultimately designated. Instead, the Board appears to be creating a one-size-fits-all, bank-centric approach that will not work well with nonbanks, spanning diverse industries unrelated to banking.

2. Nature of Risk and Adverse Consequences of Circumventing the "Predominantly Engaged" Standard

Risk, like energy, can neither be created nor destroyed, but only transferred. So when discussing systemic risk we cannot be tricked into thinking that risk disappears. It simply moves elsewhere. Our system relies on the presence of actors who view the potential rewards of accepting this risk as sufficient to prompt them to do so. If they should come to view the costs and risks as outweighing any potential reward, the flow of capital will come to a standstill.

To truly minimize the probability of future financial crises, we must understand how this risk moves and where it will show up next. Risk is managed most efficiently when it is transparent and properly understood, and the market responds with robust, efficient and liquid hedging solutions.

By creating a balanced system of clear criteria for nonbank financial companies to be subjected to systemic risk regulation, Congress went down the path of transparency to provide understandable guideposts. For instance, a corporate treasurer whose company imports a raw material from overseas, must manage currency risk, commodity price risk, interest rate risk, and operational shipping risks. By defining activities that are "financial in nature" to be different than the activities banks may undertake pursuant to section 4(k), regulators defy the clear and unambiguous command of Congress. If the above described activities were to be considered in the scope of activities that are financial in nature under a predominantly engaged test broadened by regulators, companies may conclude that some risk management techniques and heretofore efficient transactions will no longer be available, or, if they are available, they will no longer be cost effective. They will decide to "go naked" and retain more risk internally, ultimately shifting risk back to shareholders. The upshot of this is that they will hold even more precautionary cash on their balance sheets as a buffer. This will take money out of the real economy, stall economic growth, stunt the creation of new jobs, and destroy existing jobs.

3. Process Concerns

a. Lack of Transparency

We fully understand and agree that FSOC discussions regarding SIFI designations, the affairs of a designated company, and, if need be deliberations regarding the use of Title II Orderly Liquidation Authority should be kept *in camera*. The very nature of those discussions could have damaging impacts upon the markets, the company and

its investors. However, when the FSOC is acting in its quasi-legislative capacity to establish the framework for its designation work, its actions should be subject to the same procedural safeguards that typically attach to such rulemaking efforts. This ensures that regulatory deliberations are happening with the same level of transparency and care as the deliberation of prudential regulators.

By not following basic procedural standards and safeguards generally applicable to federal regulators, the FSOC has created needless uncertainty and concern as to the logic and motivations behind the regulations it promulgates. It reduces the ability of the regulated community to understand and comply with FSOC's rules. Although the FSOC has provided an opportunity to comment, in many instances there is no evidence that the comments are considered and, if so, to what extent. There is often no reasoned explanation in final rules responding to the comments of the regulated community. This discourages stakeholders from providing the FSOC with informed commentary that may improve a proposed regulation. It also decreases the regulated community's acuity as to what regulators may decree next, which increases uncertainty in the business community.

The Chamber believes that Congress needs to ensure that when the FSOC issues regulations bearing on a matter as important as the security of the financial markets of America and the world, it abides by the same legal and procedural requirements that other administrative agencies must when promulgating rules on much less significant matters.

b. Lack of Cost Benefit Analysis

Additionally, in the rulemaking process, FSOC did not provide a cost-benefit analysis to allow stakeholders to determine the potential impacts of proposed regulations. In finalizing the rules on designating companies, the FSOC went so far as to state that the designation of systemically important companies was not economically significant as the Office of Management and Budget did not deem this rule a significant regulatory action. This is logically inconsistent reasoning that either implies that systemic risk regulation is meaningless or unnecessary, or that the statement is factually incorrect in stating that the regulations will not have a cost to companies and the economy.

The Chamber believes that the FSOC should have to provide an economic analysis in promulgating a rule. The FSOC should also conduct an economic analysis during Phase 3 of the SIFI designation process to ensure that designation is the most appropriate path for a company rather than enhanced regulation by its prudential regulator. Furthermore, the Chamber believes that Congress should study the

possibility of streamlining the FSOC rulemaking along the lines of Executive Order 13563 which places upon agencies the requirement, when promulgating rules to:

1) Propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to justify);

2) Tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;

3) Select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety and other advantages; distributive impacts; and equity);

4) To the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and

5) Identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made to the public.[1]

Additionally, Executive Order 13563 states that "[i]n applying these principles, each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible."

This provides a valuable guidepost to strengthen the FSOC rulemaking process.

c. Rules Considered Out of Order and Not Completed

The consideration and promulgation of rules needed to implement Title I have been taken out of sequence and much has yet to be completed. The logical sequence of rules under Title I should be as follows: 1) the Board 's definition of "predominantly engaged in financial activities"; 2) the Board's criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank

[1] Executive Order 13563

financial companies from supervision under section 170 of the Dodd-Frank Act; 3) the FSOC's authority to require supervision and regulation of certain nonbank financial companies; and 4) the Federal Reserve's enhanced prudential standards and early remediation for covered companies. Promulgation of these rules in the proper sequence would allow interested parties, including those companies that could potentially be caught in any of the earlier rules in the logical sequence, to determine whether they will be subject to a subsequent rule and have certainty as to how any proposed subsequent rule will impact them, so that they can provide comment accordingly.

Unfortunately, financial regulators have taken a different and illogical approach. The following outlines the actual sequence of the systemic risk rulemaking process:

- October 2010 – FSOC issues advanced notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- January 2011 – FSOC issues notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- February 2011 – Federal Reserve issues notice of proposed rulemaking regarding the definitions of "predominantly engaged in financial activities" and "significant nonbank financial company."

- October 2011 – FSOC issues second notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- December 2011 – Federal Reserve issues notice of proposed rulemaking regarding enhanced prudential standards and early remediation requirements for covered companies.

- April 2012 – FSOC issues final rule regarding authority to require supervision and regulation of certain nonbank financial companies.

- April 2012 – Federal Reserve issues supplemental notice of proposed rulemaking regarding the definitions of "predominantly engaged in financial activities" and "significant nonbank financial company."

- Yet to be issued are proposed rules regarding criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision under section 170 of the Dodd-Frank Act.

This haphazard approach to incomplete rulemakings has made it impossible for stakeholders to understand how the systemic risk regulatory system will work and whether it will be subject to further rules under this regime. The Federal Reserve's rules regarding the definition of "predominantly engaged in financial activities" and the criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision should have been completed before the FSOC issued its proposal on authority to require supervision and regulation of nonbank financial companies. Instead, companies have been subject to an unfair and inappropriate rulemaking process that has not provided clarity in terms of whether they will be subject to such rules. This handicaps their ability to provide meaningful comments on the rules that should logically have come at a different point in the implementation process.

It is important also to note that although the FSOC has indeed finalized rules and guidance on the SIFI designation process, the Board has yet to finalize its rules on enhanced prudential standards. Until the Board completes this rulemaking, the FSOC cannot know what the consequences of SIFI designation are, and therefore cannot meaningfully assess whether a nonbank financial company should be designated. Accordingly, the Chamber recommends that the designation process not commence until the entire systemic risk rulemaking process is completed.

d. Regulatory Coordination and Investor Uncertainty

Obviously, the FSOC rulemakings will conflict or overlap with other pre-existing rules that may have been in place for some time. For instance, the Exchange Acts requires that companies disclose to the Securities and Exchange Commission ("SEC") and investors any conditions that are material to the company. Clearly, at some point in time, the consideration of a nonbank financial company as systemically important qualifies as a material condition that should be disclosed to investors. However, neither the FSOC nor the SEC has provided guidance on when, how, or if this consideration should be disclosed.

The Chamber recommends that the FSOC and prudential regulators examine existing regulations and coordinate an approach to give stakeholders clarity and legal certainty as to their duties and actions.

4. Other Substantive Concerns

a. One Size Does Not Fit All

The systemic risk designation process and regulation of nonbank financial companies will implicate varied companies with different business models spread over many industries. Congress recognized that the prudential regulators should take the lead in molding the appropriate regulatory structures to meet the unique needs of nonbank financial companies. This has not occurred, to date, and there is a great concern that a one-size-fits-all bank-centric approach will be imposed because of the Federal Reserve's experience as a bank regulator.

Taking a one-size-fits-all approach goes against Congressional intent as reflected in the Dodd-Frank Act. It will increase potential risk rather than reduce it. Congress clearly delineated between the treatment of systemically important nonbank financial companies and systemically important banks by setting up a detailed designation process for nonbank companies while instituting automatic designation for bank holding companies with total consolidated assets of $50 billion or more.

A one-size-fits-all approach will not produce more effective oversight. Shoehorning nonbank financial companies into a banking regulatory framework will disrupt how these companies compete within their industry and in our global economy. Each financial company fulfills the need for a specific product or service in the marketplace. In the long run, imposing bank-like regulations on a diverse group of nonbank financial companies will force these companies to alter their business model such that the financial services industry becomes homogenized. In some instances, bank-like capital requirements might make certain business lines no longer economically feasible, even though these businesses are not inherently risky. Instead of mitigating systemic risk, such regulation would concentrate it and increase it exponentially, while reducing competition, customer choice and economic efficiency. Furthermore, this would accelerate the flight to less regulated products and jurisdictions, expanding moral hazard.

Accordingly, the Chamber recommends that Congress work with FSOC to ensure that the prudential regulators have an enhanced role and develop nonbank financial systemic risk regulatory structures that more appropriately suit the different business models throughout the financial services industry.

b. Federal Reserve Discretion

In its notice of proposed rulemaking for enhanced prudential standards and

early remediation under section 165 of the Dodd-Frank Act, the Board acknowledges that the proposal is not designed or structured to address the special circumstances of nonbank financial companies. The proposal states:

"While this proposal was largely developed with large, complex bank holding companies in mind, some of the standards nonetheless provide sufficient flexibility to be readily implemented by covered companies that are not bank holding companies. In prescribing prudential standards under section 165(b) (1), the Board would [sic] to take into account the differences among bank holding companies and nonbank financial companies supervised by the Board. Following designation of a nonbank financial company by the Council, the Board would thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards and early remediation requirements should apply. The Board may, by order or regulation, tailor the application of the enhanced standards to designated nonbank companies on an individual basis or by category, as appropriate. [Footnotes omitted]"

This paragraph raises a series of important issues regarding the validity of this rulemaking proceeding with respect to SIFIs:

- Why is the Board seeking to apply the Enhanced Standards to a class of entities –nonbank financial companies—that it apparently did not have in mind when it drafted the proposal?

- What is the Board's rationale for not carefully considering the circumstances presented by nonbank financial companies that might be designated as SIFIs and to draft Enhanced Standards to address and accommodate the differences between these nonbank SIFIs and Large Bank Holding Companies ("large BHC's")?

- Has the Board considered and quantified the costs to potential SIFIs, the financial system and the economy of imposing Enhanced Standards designed for Large BHCs on nonbank SIFIs, and of SIFIs revising their business models and investment strategies to comply with Large BHC-centric metrics that may be inappropriate, ineffective and even counter-productive for achieving increased systemic financial stability?

- Why has the Board not advised the public as to which specific standards it believes can be readily implemented by non-BHC SIFIs and which it believes cannot?

- The Board appears to indicate that only after a SIFI is designated will it consider how the rules should apply to it and that, depending on that review, the Board may amend the rules or issue an order to tailor the application of the rules to a particular SIFI or a category of SIFIs. Under this approach, how can anyone, including the FSOC, a potential SIFI's functional regulators, the markets, or a potential SIFI itself, understand how the rules would apply to it if it were to be designated? The Board's indicated approach would appear to ignore the assessment made of each SIFI by the FSOC in order to make its designation. Indeed, it would put the FSOC in the position of designating a SIFI without being able properly to consider how effectively or efficiently the rules would operate to mitigate the perceived threat to financial stability posed by the company. The Board's attempt to maximize its reservation of discretion to deal with SIFIs is, therefore, not only fundamentally unfair to SIFIs but also destructive of the intended gate keeping function of the FSOC.

The proposal would apply the rules to Large BHCs and SIFIs. As a result, it is incumbent on the Board to consider how the rules would apply to both categories of institutions. Without providing commenters with a reasonable description of how the rules would apply to the wide variety of unidentified companies that may be designated as SIFIs, the Board's approach does not the public to provide input that the promulgating agency is required to evaluate and incorporate into its final rulemaking, including in a statement of basis and purpose. Here, the Board acknowledges that it has not made any effort to craft the Rules with SIFIs in mind. As a result, a potential nonbank SIFI is subject to the risk that the Board will adopt Rules that may not appropriately apply to the company, but that nevertheless on their face would be applicable to critical aspects of the company's operations. The Rules provide no indication of whether or how they would be tailored to the actual situation and circumstances of a newly designated SIFI.

To take just one example, a potential SIFI may operate under a capital structure and regulatory capital requirements that do not meaningfully correlate with the capital standards to which Large BHCs have long been subject. In such a situation, the potential SIFI might not have sufficient capital to meet the capital requirements imposed under the rules because of its organizational form, statutory or regulatory restrictions or long-standing business or operating considerations. If the company were to be designated as a nonbank SIFI and had inadequate capital under Large BHC-centric regulatory capital requirements, it could be subject to severe regulatory restrictions on its business under the early remediation structure established by the rules.

If the Board proceeds on this course, it would place potential nonbank SIFIs in the very difficult position of being forced to speculate both on (i) whether it would ultimately be designated as a SIFI and (ii) how the Board might seek to tailor the application of the Large BHC-centric rules to it.

During what could be an extended period of uncertainty, a potential SIFI would have to decide whether to proactively restructure its business operations, capital structure and strategic plan to seek to respond to a potentially inappropriate and inapplicable regulatory structure. To the extent that this situation holds the potential of significant harm to the company, including the prospect of adverse market valuation movements in response to public disclosures regarding the potential adverse impact of the rules if applied to the company following its designation, it underscores the defective nature of the current rulemaking proceeding and presents a presumably unintended and wholly avoidable threat to financial stability and the economy. Moreover, restructuring or other actions taken by potential SIFIs to address the possible application of the rules to them may have an adverse impact on financial markets and a destabilizing impact on U.S. financial stability.

A fundamental element of a rulemaking proceeding is the promulgating agency's obligation to support the policy and legal choices that it has made in light of the comments received. The statement of basis and purpose should lay out the agency's thought processes and evaluation of the arguments in the comments it received. If the Board continues on the path that it has outlined in the proposal, it will not be able to meet this requirement and will not provide fair or transparent treatment to companies that are ultimately designated as SIFIs. Therefore, we recommend that the Board terminate this rulemaking proceeding with respect to SIFIs and expressly limit it to companies that qualify as Large BHCs under section 252.12(d)(2) of the Proposal. In addition, in order to satisfy the statutory requirements of section 165 of the Dodd Frank Act and the requirements regarding notice and comment and the statement of basis and purpose, the Board should undertake a separate SIFI rulemaking that meets the principles enumerated above.

The current proposed rules give the Board wide ranging discretion to change rules and practices, seemingly on a whim. This fails to give designated companies, or potentially designated companies any legal certainty and harms the ability of investors to appropriatey evaluate their options. This will create economic harm.

5. Conclusion

In crafting Title I, Congress wisely went to great pains to create a balanced approach to address systemic risk while minimizing the impact upon non-financial

companies. The regulators are, contrary to Congressional directive, creating an open-ended hunting license that will bag companies, which if the law was followed, would have been considered off limits. By disregarding the bounds established by Congress, the regulators are possibly creating the unintended consequences Congress hoped to avoid creating adverse impacts within the nonbank sectors of the economy. In recognizing that we must observe and manage systemic risk, we must at the same time acknowledge that reasonable risk taking is a necessary component for growth conducive for prosperity.

This is a difficult balance to achieve, but one that must be struck in order to have the efficient and effective capital markets needed for businesses and a growing economy that creates jobs.

I will be happy to take any questions that you may have.

http://www.treasury.gov/connect/blog/Pages/Importance-of-Remittances-through-Legal-Channels-to-Somalia.aspx

Treasury Notes

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The Importance of Remittances through Legal Channels to Somalia

By: Scott Rembrandt
12/23/2011

The U.S. Department of the Treasury, along with the rest of the U.S. government remains deeply concerned about the ongoing humanitarian crisis in the Horn of Africa. To help combat the famine, the U.S. government has become the largest humanitarian donor to the region, providing more than $870 million to meet ongoing and urgent humanitarian needs, including nearly $205 million for Somalia. President Obama recently announced an additional $113 million in emergency relief funding for the region to support urgently needed food, health, shelter, water and assistance needs.

We also recognize the important role that remittances play in meeting these urgent needs, as so many Somali-Americans have sent money to their loved ones in the region struggling to survive. Treasury engages regularly with the Somali-American community and the financial institutions that service them in Minneapolis and elsewhere to promote the continued use of legitimate and transparent methods for these critical transfers. Maintaining safe, transparent payment channels is of the utmost importance given that funds have also been transferred to Al-Shabaab, an internationally-sanctioned terrorist group – something financial institutions work diligently to prevent.

It is important to note that the Treasury Department does not have the authority to direct any financial institution to open or maintain a particular account or relationship. The decision to maintain any financial relationship is made by each financial institution itself. Such a decision is often based upon a number of factors, including the bank's capacity to effectively manage money laundering and terrorist financing risks. Financial institutions are required to identify, assess and take steps to design and implement controls that are appropriate to manage risks, in

compliance with their obligations under the Bank Secrecy Act, as well as under counter-financing of terrorism and sanctions laws.

The Treasury Department expects financial institutions, in their compliance with the Bank Secrecy Act, to reasonably discharge their due diligence obligations -- not that they be infallible in doing so. The Department also expects financial institutions to take appropriate steps to comply with sanctions and counter-financing of terrorism laws. There is no assumption on the part of Treasury that money transmitters present a uniform or unacceptably high risk of money laundering, terrorist financing or sanctions violations.

In 2005, Treasury's Financial Crimes Enforcement Network (FinCEN) and the Federal Banking Agencies issued a joint statement recognizing the importance of money services businesses, including money transmitters, that comply with the law having reasonable access to banking services. As noted in subsequent guidance, banks are expected to apply Bank Secrecy Act requirements to money services business (MSB) customers on a risk-basis as they do with all accountholders. Banks do this by first assessing the risks associated with the particular customer and then taking appropriate steps to manage the identified risks. Banks thus have the flexibility to provide services to a wide range of MSBs, even ones deemed high-risk, and remain in compliance with the Bank Secrecy Act.

It is the view of the Treasury Department that financial institutions that establish and maintain appropriate risk-based anti-money laundering programs will be well-positioned to appropriately manage such accounts, prevent illicit transactions, and avoid enforcement action.

The Treasury Department believes that the Somali-American community will continue to have legitimate and transparent methods to transfer funds to Somalia and we look forward to continuing our active engagement of all stakeholders, including the Somali community, financial institutions, regulators, and law enforcement on this issue.

Scott Rembrandt is a Policy Advisor in the Office of Terrorist Financing and Financial Crimes at the U.S. Department of the Treasury.

Posted in: Terrorism and Financial Intelligence

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Case No. IA-2013-300350-1

The Honorable Keith Ellison
U.S. House of Representatives
Washington, DC 20515

Dear Representative Ellison:

This responds to your letter dated January 30, 2013, to the Office of Foreign Assets Control ("OFAC"), seeking guidance on certain prohibitions contained in the Iranian Transactions and Sanctions Regulations, 31 C.F.R. Part 560 (the "ITSR"). Specifically, you seek clarification as to whether a U.S. financial institution is authorized to open and operate bank accounts on behalf of Iranian college students residing in the United States pursuant to lawfully issued visas.

Section 560.204 of the ITSR prohibits the exportation, reexportation, sale, or supply of any goods, technology, or services, directly or indirectly, from the United States or by a U.S. person, wherever located, to Iran or the Government of Iran. ITSR, § 560.204. Additionally, the ITSR generally prohibit U.S. persons, wherever located, from engaging in any transaction or dealing in or related to (1) goods, technology, or services for exportation, reexportation, sale, or supply, directly or indirectly, to Iran or the Government of Iran, or (2) goods or services of Iranian origin or owned or controlled by the Government of Iran. ITSR, § 560.206(a). This prohibition includes but is not limited to purchasing, selling, transporting, swapping, brokering, approving, financing, facilitating, or guaranteeing. ITSR, § 560.206(b). The ITSR define the term *U.S. person* to mean any United States citizen, permanent resident alien, entity organized under the laws of the United States (including foreign branches), or any person in the United States. ITSR, § 560.314.

However, section 560.505(a) of the ITSR contains a general license authorizing persons who hold visas in certain non-immigrant visa categories (including category F for student visas) to carry out in the United States those activities for which such a visa has been granted by the U.S. State Department. Subject to certain exceptions, U.S. persons (*e.g.*, visitors, U.S. permanent residents, and U.S. citizens) are authorized to engage in any transactions ordinarily incident to a transaction that is either specifically or generally licensed, provided the transaction is ordinarily incident to a licensed activity and necessary to give effect to the licensed transactions. ITSR, § 560.405.

The ITSR also authorize United States depository institutions to process transfers of funds to or from Iran, or for the direct or indirect benefit of persons in Iran or the Government of Iran, if the transfer arises from, and is ordinarily incident and necessary to give effect to, an underlying transaction that has been authorized by a specific or a general license, such as section 560.505 of the ITSR, and does not involve debiting or crediting an Iranian account. ITSR, § 560.516(a). The term "Iranian account" is defined as accounts of persons who are ordinarily resident in Iran, except when such persons are not located in Iran, or of the Government of Iran, maintained on the books of either a United States depository institution or a United States registered broker or dealer in securities. ITSR, § 560.320.

Therefore, the authorities described above generally authorize U.S. financial institutions to open and maintain accounts on behalf of Iranian students who are studying or physically present in the United States, without additional authorization from OFAC. Please be advised, however, that pursuant to section 560.517(a)(2) of the ITSR, the financial institutions are required to close out an "Iranian account" and make a lump sum transfer only to the account party of all remaining funds and assets in the account once the person ordinarily resident in Iran returns to Iran.

If you have any additional questions, you may refer to the OFAC website at www.treasury.gov/ofac or call our office at (202) 622-2480.

Sincerely,

July 8, 2013

Andrea Gacki
Assistant Director for Licensing
Office of Foreign Assets Control

Date

United States Government Accountability Office

GAO

Report to Congressional Requesters

January 2013

FINANCIAL REGULATORY REFORM

Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act

GAO
Accountability * Integrity * Reliability

GAO-13-180

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Highlights

Highlights of GAO-13-180, a report to congressional requesters

January 2013

FINANCIAL REGULATORY REFORM

Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act

Why GAO Did This Study

The 2007-2009 financial crisis threatened the stability of the U.S. financial system and the health of the U.S. economy. To address regulatory gaps and other problems revealed by the crisis, Congress enacted the Dodd-Frank Act. Federal regulators will need to issue hundreds of rules to implement the act. Industry representatives, academics, and others generally have supported the act's goal of enhancing U.S. financial stability, but implementation of certain of the act's provisions has led to much debate. These experts have expressed a wide range of views on the potential positive and negative effects that the act could have on the U.S. financial system and broader economy.

GAO was asked to examine the (1) losses associated with the recent financial crisis; (2) benefits of the act for the U.S. financial system and the broader economy; and (3) costs of the act's reforms. GAO reviewed empirical and other studies on the impacts of financial crises and the Dodd-Frank reforms, as well as congressional testimonies, comment letters, and other public statements by federal regulators, industry representatives, and others. GAO obtained and analyzed data on agency resources devoted to the act's implementation. GAO also obtained perspectives from regulators, academics, and representatives of industry and public interest groups through interviews and an expert roundtable held with the assistance of the National Academy of Sciences. GAO provided a draft of this report to the financial regulators for review and comment and received technical comments, which were incorporated as appropriate.

View GAO-13-180. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

What GAO Found

The 2007-2009 financial crisis has been associated with large economic losses and increased fiscal challenges. Studies estimating the losses of financial crises based on lost output (value of goods and services not produced) suggest losses associated with the recent crisis could range from a few trillion dollars to over $10 trillion. Also associated with the crisis were large declines in employment, household wealth, and other economic indicators. Some studies suggest the crisis could have long-lasting effects: for example, high unemployment, if persistent, could lead to skill erosion and lower future earnings for those affected. Finally, since the crisis began, federal, state, and local governments have faced greater fiscal challenges, in part because of reduced tax revenues from lower economic activity and increased spending to mitigate the impact of the recession.

While the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act) reforms could enhance the stability of the U.S. financial system and provide other benefits, the extent to which such benefits materialize will depend on many factors whose effects are difficult to predict. According to some academics, industry representatives, and others, a number of the act's provisions could help reduce the probability or severity of a future crisis and thereby avoid or reduce the associated losses. These include subjecting large, complex financial institutions to enhanced prudential supervision, authorizing regulators to liquidate a financial firm whose failure could pose systemic risk, and regulating certain complex financial instruments. In contrast, some experts maintain these measures will not help reduce the probability or severity of a future crisis, while others note that their effectiveness will depend on how they are implemented by regulators, including through their rulemakings, and other factors, such as how financial firms respond to the new requirements. Quantifying the act's potential benefits is difficult, but several studies have framed potential benefits of certain reforms by estimating output losses that could be avoided if the reforms lowered the probability of a future crisis.

Federal agencies and the financial industry are expending resources to implement and comply with the Dodd-Frank Act. First, federal agencies are devoting resources to fulfill rulemaking and other new regulatory responsibilities created by the act. Many of these agencies do not receive any congressional appropriations, limiting federal budget impacts. Second, the act imposes compliance and other costs on financial institutions and restricts their business activities in ways that may affect the provision of financial products and services. While regulators and others have collected some data on these costs, no comprehensive data exist. Some experts stated that many of the act's reforms serve to impose costs on financial firms to reduce the risks they pose to the financial system. Third, in response to reforms, financial institutions may pass increased costs on to their customers. For example, banks could charge more for their loans or other services, which could reduce economic growth. Although certain costs, such as paperwork costs, can be quantified, other costs, such as the act's impact on the economy, cannot be easily quantified. Studies have estimated the economic impact of certain of the act's reforms, but their results vary widely and depend on key assumptions. Finally, some experts expressed concern about the act's potential unintended consequences and their related costs, adding to the challenges of assessing the benefits and costs of the act.

Contents

Figures

Abbreviations

AIG	American International Group, Inc.
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BLS	Bureau of Labor Statistics
CBO	Congressional Budget Office
CCP	central counterparty
CDS	credit default swaps

CFTC	Commodity Futures Trading Commission
CFPB	Bureau of Consumer Financial Protection
CPP	Capital Purchase Program
CPSS	Committee on Payment and Settlement Systems
DGP	Debt Guarantee Program
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FHFB	Federal Housing Finance Board
FRBNY	Federal Reserve Bank of New York
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FTE	full-time equivalent
GDP	gross domestic product
GSE	government-sponsored enterprise
HERA	Housing and Economic Recovery Act of 2008
HUD	Department of Housing and Urban Development
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MMMF	money market mutual fund
NAS	National Academy of Sciences
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OLA	orderly liquidation authority
OTC	over-the-counter
OTS	Office of Thrift Supervision
OFR	Office of Financial Research
QM	qualified mortgage
QRM	qualified residential mortgage
SEC	Securities and Exchange Commission
SEF	swap execution facility
SCAP	Supervisory Capital Assessment Program
S&L	savings and loan
SIFI	systemically important financial institutions
TAGP	Transaction Account Guarantee Program
TLGP	Temporary Liquidity Guarantee Program

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

January 16, 2013

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Michael E. Capuano
Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

The 2007-2009 financial crisis threatened the stability of the U.S. financial system—composed of financial institutions, markets, and infrastructure—and the health of the U.S. economy.[1] At the peak of the crisis, the federal government introduced unprecedented support for financial markets, providing hundreds of billions of dollars of capital and over a trillion dollars of emergency loans to financial institutions. Many households suffered as a result of falling asset prices, tightening credit, and increasing unemployment. While many factors likely contributed to the crisis and the relative role of these factors is subject to debate, gaps and weaknesses in the supervision and regulation of the U.S. financial system generally played an important role.[2] To address such shortcomings, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[3] As summarized on the Senate Banking Committee's website, the act seeks to (1) address risks to the stability of the U.S. financial system, in part through the creation of the Financial

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[1]As discussed below, no universal or widely accepted definition of a financial crisis exists. Indeed, no clear consensus exists on when the recent financial crisis started or ended (if yet). In a number of speeches, officials from the Board of Governors of the Federal Reserve System and several academics have dated the crisis as starting in 2007 and ending in 2009. We are adopting that time frame, although others sometimes date the crisis as starting in 2008 and ending in 2009.

[2]As discussed in the background section of this report, other factors that are thought to have contributed to the crisis include financial innovations and economic conditions, characterized by accommodative monetary policies, ample liquidity and availability of credit, and low interest rates that spurred housing investment.

[3]Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Stability Oversight Council (FSOC), (2) end too-big-to-fail bailouts of large, complex financial institutions, (3) increase transparency and regulation for certain complex financial instruments, and (4) strengthen protections for consumers and investors.[4]

Federal financial regulators and other agencies are continuing to make progress in implementing the Dodd-Frank Act's numerous provisions, which may require hundreds of rulemakings. While the financial services industry, academics, and others generally have supported the Dodd-Frank Act's goal of enhancing the stability of the U.S. financial system, the act's implementation has not been free of controversy or debate. For example, a consensus exists neither on the extent to which the act will help to reduce the likelihood and severity of future financial crises nor on the magnitude of the costs that the act, generally, and its regulations, specifically, will impose on U.S. financial institutions and the U.S. economy. The Dodd-Frank Act has not yet been fully implemented; thus, its impacts have not fully materialized. Nonetheless, analyses of the potential and actual impacts can help inform policymakers about the ongoing implementation of the act's reforms.

As requested, the objectives of this report are to describe what is known about

- the losses and related economic impacts associated with the 2007-2009 financial crisis;
- the benefits of the Dodd-Frank Act, particularly its key financial stability provisions, for the U.S. financial system and broader economy; and
- the costs associated with the act, particularly its key financial stability provisions.

To address our objectives, we reviewed and analyzed academic and other studies that assess the economic impacts of financial crises or financial regulatory reforms, including the Dodd-Frank Act. We reviewed the methodological approaches of selected studies and determined that they were sufficient for our purposes. However, the results should not

[4]U.S. Senate, Committee on Banking, Housing, and Urban Affairs, *Dodd-Frank Wall Street Reform: Conference Report Summary,* accessed December 17, 2012, http://banking.senate.gov/public/index.cfm?FuseAction=Issues.View&Issue_id=84d77b9f-c7ab-6fe2-4640-9dd18189fb23.

necessarily be considered as definitive, given the methodological or data limitations contained in the studies individually and collectively. To show changes in economic indicators following the start of the financial crisis, we obtained and analyzed data from the Bureau of Economic Analysis, Bureau of Labor Statistics, National Bureau of Economic Research, and other sources. We obtained and summarized data on the incremental budgetary costs associated with the act's implementation for 10 federal entities: the Board of Governors of the Federal Reserve System (Federal Reserve); Commodity Futures Trading Commission (CFTC); Federal Deposit Insurance Corporation (FDIC); Federal Housing Finance Agency (FHFA); Office of the Comptroller of the Currency (OCC); Securities and Exchange Commission (SEC); Department of the Treasury (Treasury); Bureau of Consumer Financial Protection, commonly known as the Consumer Financial Protection Bureau (CFPB); FSOC; and the Office of Financial Research (OFR). For parts of our methodology that involved the analysis of computer-processed data, we assessed the reliability of these data and determined that they were sufficiently reliable for our purposes. Through interviews and an expert roundtable we held with the assistance of the National Academy of Sciences, we obtained perspectives from academics; current and former federal financial regulators; representatives of industry, public interest, and investor groups; and other experts on the potential benefits and costs of the act's reforms. In addition, we reviewed relevant reports and public statements by these groups as well as Dodd-Frank Act rules and comment letters. Finally, we reviewed prior GAO work on the fiscal outlook for federal, state, and local governments and on financial regulatory reform. Appendix I contains additional information on our scope and methodology.

We conducted this performance audit from November 2011 to January 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

U.S. Financial Regulatory Framework

The financial regulatory framework in the United States was built over more than a century, largely in response to crises and significant market developments. As a result, the regulatory system is complex and fragmented.[5] While the Dodd-Frank Act has brought additional changes, including the creation of new regulatory entities and the consolidation of some regulatory responsibilities that had been shared by multiple agencies, the U.S. financial regulatory structure largely remains the same. It is a complex system of multiple federal and state regulators, as well as self-regulatory organizations, that operates largely along functional lines. The U.S. regulatory system is described as "functional" in that financial products or activities are generally regulated according to their function, no matter who offers the product or participates in the activity.

Banking Regulators

In the banking industry, the specific regulatory configuration depends on the type of charter the banking institution chooses. Depository institution charter types include

- *commercial banks*, which originally focused on the banking needs of businesses but over time have broadened their services;
- *thrifts*, which include savings banks, savings associations, and savings and loans and were originally created to serve the needs—particularly the mortgage needs—of those not served by commercial banks; and
- *credit unions*, which are member-owned cooperatives run by member-elected boards with an historical emphasis on serving people of modest means.

These charters may be obtained at the state or federal level. State regulators charter institutions and participate in their oversight, but all institutions that have federal deposit insurance have a federal prudential regulator. The federal prudential regulators—which generally may issue regulations and take enforcement actions against industry participants

[5]For a more detailed discussion of the evolution of the U.S. financial regulatory framework before the enactment of the Dodd-Frank Act, see GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

within their jurisdiction—are identified in table 1. The act eliminated the Office of Thrift Supervision (OTS) and transferred its regulatory responsibilities to OCC, the Federal Reserve, and FDIC.[6] To achieve their safety and soundness goals, bank regulators establish capital requirements, conduct onsite examinations and off-site monitoring to assess a bank's financial condition, and monitor compliance with banking laws. Regulators also issue regulations, take enforcement actions, and close banks they determine to be insolvent.

Table 1: Federal Prudential Regulators and Their Basic Functions

Agency	Basic function
Office of the Comptroller of the Currency	Charters and supervises national banks and federal thrifts.
Board of Governors of the Federal Reserve System	Supervises state-chartered banks that opt to be members of the Federal Reserve System, bank holding companies, thrift holding companies and the nondepository institution subsidiaries of those institutions, and nonbank financial companies designated by the Financial Stability Oversight Council.
Federal Deposit Insurance Corporation	Supervises FDIC-insured state-chartered banks that are not members of the Federal Reserve System, as well as federally insured state savings banks and thrifts; insures the deposits of all banks and thrifts that are approved for federal deposit insurance; and resolves all failed insured banks and thrifts and has been given the authority to resolve large bank holding companies and nonbank financial companies that are subject to supervision by the Board of Governors of the Federal Reserve System.
National Credit Union Administration	Charters and supervises federally chartered credit unions and insures savings in federal and most state-chartered credit unions.

Sources: OCC, Federal Reserve Board, FDIC, and NCUA.

Holding companies that own or control a bank or thrift are subject to supervision by the Federal Reserve. The Bank Holding Company Act of 1956 and the Home Owners' Loan Act set forth the regulatory frameworks for bank holding companies and savings and loan (S&L) holding companies, respectively.[7] Before the Dodd-Frank Act, S&L holding companies had been subject to supervision by OTS and a different set of regulatory requirements from those of bank holding companies. The

[6]OTS chartered and supervised federally chartered savings institutions and savings and loan holding companies. Rule-making authority previously vested in OTS was transferred to OCC for savings associations and to the Federal Reserve for savings and loan holding companies. Other authorities were transferred to OCC, FDIC, and the Federal Reserve. 12 U.S.C. § 5412.

[7]Pub. L. No. 84-511, 70 Stat. 133 (1956) and Pub. L. No. 73-43, 48 Stat. 128 (1933). Bank holding companies are companies that own or control a bank, as defined in the Bank Holding Company Act. S&L holding companies are companies that own or control an S&L.

Dodd-Frank Act made the Federal Reserve the regulator of S&L holding companies and amended the Home Owners' Loan Act and the Bank Holding Company Act to create certain similar requirements for both bank holding companies and S&L holding companies.[8] The Dodd-Frank Act also grants new authorities to FSOC to designate nonbank financial companies for supervision by the Federal Reserve.

Securities and Futures Regulators

The securities and futures markets are regulated under a combination of self-regulation (subject to oversight by the appropriate federal regulator) and direct oversight by SEC and CFTC, respectively.[9] SEC regulates the securities markets, including participants such as securities exchanges, broker-dealers, investment companies, and investment advisers. SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. In the securities industry, certain self-regulatory organizations—including the securities exchanges and the Financial Industry Regulatory Authority—have responsibility for overseeing the securities markets and their members; establishing the standards under which their members conduct business; monitoring business conduct; and bringing disciplinary actions against members for violating applicable federal statutes, SEC's rules, and their own rules.

CFTC is the primary regulator of futures markets, including futures exchanges and intermediaries, such as futures commission merchants.[10] CFTC's mission is to protect market users and the public from fraud, manipulation, abusive practices, and systemic risk related to derivatives that are subject to the Commodity Exchange Act, and to foster open, competitive, and financially sound futures markets. Like SEC, CFTC oversees the registration of intermediaries and relies on self-regulatory

[8] For a more detailed discussion of the regulatory framework for bank holding companies and S&L holding companies, see GAO, *Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions*, GAO-12-160 (Washington, D.C.: Jan. 19, 2012).

[9] Certain securities activities also are overseen by state government entities.

[10] Futures commission merchants are individuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept payment from or extend credit to those whose orders are accepted. Firms and individuals who trade futures with the public or give advice about futures trading must be registered with the National Futures Association, the industrywide self-regulatory organization for the U.S. futures industry.

organizations, including the futures exchanges and the National Futures Association, to establish and enforce rules governing member behavior. In addition, Title VII of the Dodd-Frank Act expands regulatory responsibilities for CFTC and SEC by establishing a new regulatory framework for swaps. The act authorizes CFTC to regulate "swaps" and SEC to regulate "security-based swaps" with the goals of reducing risk, increasing transparency, and promoting market integrity in the financial system.[11]

Consumer Financial Protection Bureau

The Dodd-Frank Act established CFPB as an independent bureau within the Federal Reserve System and provided it with rule-making, enforcement, supervisory, and other powers over many consumer financial products and services and many of the entities that sell them.[12] Certain consumer financial protection functions from seven existing federal agencies were transferred to CFPB.[13] Consumer financial products and services over which CFPB has primary authority include deposit taking, mortgages, credit cards and other extensions of credit, loan servicing, debt collection, and others. CFPB is authorized to supervise certain nonbank financial companies and large banks and credit unions with over $10 billion in assets and their affiliates for consumer protection purposes. CFPB does not have authority over most insurance activities or most activities conducted by firms regulated by SEC or CFTC.

Federal Housing Finance Agency

The Housing and Economic Recovery Act of 2008 (HERA) created FHFA to oversee the government-sponsored enterprises (GSE): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.[14] Fannie Mae and Freddie Mac were created by Congress as private, federally chartered

[11] A swap is a type of derivative that involves an ongoing exchange of one or more assets, liabilities, or payments for a specified period. Financial and nonfinancial firms use swaps and other over-the-counter derivatives to hedge risk, or speculate, or for other purposes. Swaps include interest rate swaps, commodity-based swaps, and broad-based credit default swaps. Security-based swaps include single-name and narrow-based credit default swaps and equity-based swaps. For the purposes of this report, we use "swaps" to refer to both "swaps" and "security-based swaps."

[12] 12 U.S.C. §§ 5481–5603.

[13] These agencies included the Federal Reserve, FDIC, the Federal Trade Commission, the Department of Housing and Urban Development, the National Credit Union Administration, OCC, and OTS.

[14] Pub. L. No. 110-289, 122 Stat. 2654 (2008).

companies to provide, among other things, liquidity to home mortgage markets by purchasing mortgage loans, thus enabling lenders to make additional loans. The system of 12 Federal Home Loan Banks provides funding to support housing finance and economic development. Until enactment of HERA, Fannie Mae and Freddie Mac had been overseen since 1992 by the Office of Federal Housing Enterprise Oversight (OFHEO), an agency within the Department of Housing and Urban Development (HUD), and the Federal Home Loan Banks were subject to supervision by the Federal Housing Finance Board (FHFB), an independent regulatory agency.[15] In July 2008, HERA created FHFA to establish more effective and more consistent oversight of the three housing GSEs.[16] Given their precarious financial condition, Fannie Mae and Freddie Mac were placed in conservatorship in September 2008, with FHFA serving as the conservator under powers provided in HERA.

Federal Insurance Office

While insurance activities are primarily regulated at the state level, the Dodd-Frank Act created the Federal Insurance Office within Treasury to monitor issues related to regulation of the insurance industry.[17] The Federal Insurance Office is not a regulator or supervisor, and its responsibilities include identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system.

Financial Stability Oversight Council and Office of Financial Research

The Dodd-Frank Act established FSOC to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Dodd-Frank Act also established OFR within Treasury to serve FSOC and its member agencies by improving the quality, transparency, and accessibility of financial data and information; conducting and sponsoring

[15]OFHEO regulated Fannie Mae and Freddie Mac on matters of safety and soundness, while HUD regulated their mission-related activities. FHFB served as the safety and soundness and mission regulator of the Federal Home Loan Banks.

[16]With respect to Fannie Mae and Freddie Mac, the law gave FHFA such new regulatory authorities as the power to regulate the retained mortgage portfolios, to set more stringent capital standards, and to place a failing entity in receivership. In addition, the law provides FHFA with funding outside the annual appropriations process. The law also combined the regulatory authorities for all the housing GSEs that were previously distributed among OFHEO, FHFB, and HUD.

[17]31 U.S.C. § 313.

research related to financial stability; and promoting best practices in risk management.[18]

FSOC's membership consists of the Secretary of the Treasury, who chairs the council, and the heads of CFPB, CFTC, FDIC, the Federal Reserve, FHFA, the National Credit Union Administration, OCC, SEC, the directors of OFR and the Federal Insurance Office, representatives from state-level financial regulators, and an independent member with insurance experience.

Financial Crises

There is no universally accepted definition of a financial crisis. Some academic studies identify three major types of financial crises: banking crises, public debt crises, and currency crises.[19] The most recent financial crisis in the United States is widely considered to have been a banking crisis. While researchers have defined banking crises in different ways, their definitions generally focus on indicators of severe stress on the financial system, such as runs on financial institutions or large-scale government assistance to the financial sector. The large increases in public debt that tend to follow the onset of a banking crisis can make a country more susceptible to a public debt crisis.

Studies reviewing historical banking crises in the United States and other countries found that such crises were associated with large losses in output (the value of goods and services produced in the economy) and employment that can persist for years. A disruption to the financial system can have a ripple effect through the economy, harming the broader economy through several channels. For example, some studies identify ways that strains in the financial system can negatively impact the cost

[18] 12 U.S.C. §§ 5321–5333. For additional information on FSOC and OFR, see GAO, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions*, GAO-12-886 (Washington, D.C.: Sept. 11, 2012).

[19] Public debt crises can occur when rising levels of government debt lead investors to lose confidence in the ability of a country to repay its debts, causing the country's borrowing costs to surge and forcing large cuts to public spending. Currency crises can occur when there is a speculative attack on the foreign exchange value of a currency, causing a sharp depreciation in the currency or forcing authorities to defend the value of the currency by selling foreign exchange reserves and raising domestic interest rates.

and availability of credit and, in turn, reduce total output.[20] During the recent crisis, certain securitization markets collapsed and households and businesses faced tightened credit conditions. Higher funding costs for firms in the form of higher interest rates and lower equity prices can contribute to declines in investment. Furthermore, as asset prices fall, declines in the wealth and confidence of consumers, businesses, and investors also can contribute to output declines. Historically, governments have provided substantial assistance to financial institutions during banking crises to avert more severe disruptions to the key functions performed by the financial system.

The causes of the 2007-2009 crisis are complex and remain subject to debate and ongoing research. According to many researchers, around mid-2007, losses in the mortgage market triggered a reassessment of financial risk in other debt instruments and sparked the financial crisis. Uncertainty about the financial condition and solvency of financial entities resulted in a liquidity and credit crunch that made the financing on which many businesses and individuals depend increasingly difficult to obtain.[21] By late summer of 2008, the ramifications of the financial crisis ranged from the failure of financial institutions to increased losses of individual savings and corporate investments.

Academics and others have identified a number of factors that may have helped set the stage for problems in the mortgage market and the broader financial system. These factors, in no particular order, include

- financial innovation in the form of asset securitization, which reduced mortgage originators' incentives to be prudent in underwriting loans and made it difficult to understand the size and distribution of loss exposures throughout the system;
- imprudent business and risk management decisions based on the expectation of continued housing price appreciation;

[20]See, for example, Basel Committee on Banking Supervision, *The Transmission Channels between the Financial and Real Sectors: A Critical Survey of the Literature*. Working paper No. 18 (Basel, Switzerland: February 2011).

[21]During the crisis, market liquidity and funding liquidity declined in certain markets. To function efficiently, the securities markets need market liquidity, generally defined as the ability to buy and sell a particular asset without significantly affecting its price. In contrast to market liquidity, which is an asset-specific characteristic, funding liquidity generally refers to the availability of funds in the market that firms can borrow to meet their obligations.

- faulty assumptions in the models used by credit rating agencies to rate mortgage-related securities;
- gaps and weaknesses in regulatory oversight, which allowed financial institutions to take excessive risks by exploiting loopholes in capital rules and funding themselves increasingly with short-term liabilities;
- government policies to increase homeownership, including the role of Fannie Mae and Freddie Mac in supporting lending to higher-risk borrowers; and
- economic conditions, characterized by accommodative monetary policies, ample liquidity and availability of credit, and low interest rates that spurred housing investment.

The United States periodically has experienced banking crises of varying severity. The financial crisis that began in 2007 was the most severe banking crisis experienced by the United States since the 1930s. While this most recent financial crisis may have had some new elements—such as the role of asset securitization in spreading risks across the financial system—studies have found that it followed patterns common to past crises in the United States and other countries. For example, experts have noted that the recent crisis, like many past crises, was preceded by an asset price boom that was accompanied by an excessive buildup in leverage.[22] Another common pattern between the recent and past crises has been the buildup of risks and leverage in unregulated or less regulated financial institutions. While academic studies have used different criteria to identify and date banking crises, studies we reviewed identify the following episodes as U.S. banking crises since the Civil War: the banking panics of 1873, 1893, 1907, and the 1930s; the Savings and Loan Crisis that began in the1980s; and the 2007-2009 crisis. The studies do not consider the stock market crash of 1987 or the bursting of the technology bubble during 2000-2001 to be banking crises, because neither placed severe strains on the financial system that threatened the economy.

[22] Leverage traditionally has referred to the use of debt, instead of equity, to fund an asset and been measured by the ratio of total assets to equity on the balance sheet. Leverage also can be used to increase an exposure to a financial asset without using debt, such as by using derivatives. In that regard, leverage can be defined broadly as the ratio between some measure of risk exposure and capital that can be used to absorb unexpected losses from the exposure.

2007-2009 Financial Crisis Was Associated with Large Economic Losses and Increases in Government Debt

Several studies measure the overall economic costs associated with past financial crises based on the decline in economic output (the value of goods and services produced in the economy) relative to some benchmark, such as the long-term trend in output. While using a variety of methods to quantify these output losses, the studies generally have found the losses from past financial crises to be very large. Some of these studies also analyze changes in unemployment, household wealth, and other economic indicators to show the effects of the crises at a more granular level. In addition, some studies use measures of fiscal costs—such as increases in government debt—to analyze the losses associated with financial crises. In the following section, we review what is known about the losses associated with the recent financial crisis based on these measures.

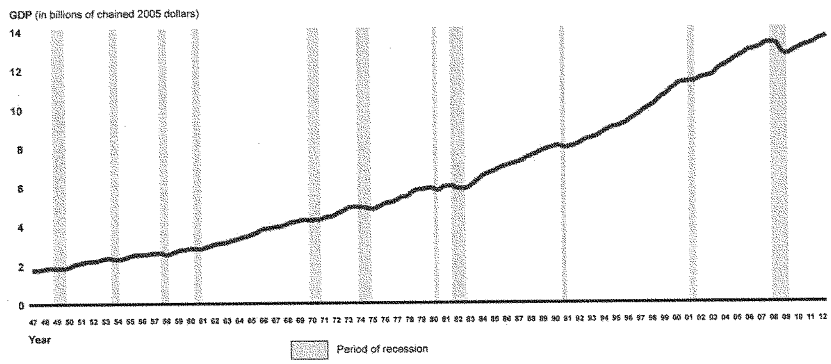
Studies Generally Find That the Recent Crisis Was Associated with Large Losses in Economic Output, but Estimates of Such Losses Vary and Depend on Several Assumptions

The 2007-2009 financial crisis, like past financial crises, was associated with not only a steep decline in output but also the most severe economic downturn since the Great Depression of the 1930s (see fig. 1). According to a study, in the aftermath of past U.S. and foreign financial crises, output falls (from peak to trough) an average of over 9 percent and the associated recession lasts about 2 years on average.[23] The length and severity of this economic downturn was roughly consistent with the experience of past financial crises. The U.S. economy entered a recession in December 2007, a few months after the start of the financial crisis.[24] Between December 2007 and the end of the recession in June 2009, U.S. real gross domestic product (GDP) fell from $13.3 trillion to $12.7 trillion (in 2005 dollars), or by nearly 5 percent. As shown in figure 1, real GDP did not regain its pre-recession level until the third quarter of 2011.

[23]Carmen M. Reinhart and Kenneth S. Rogoff, *The Aftermath of Financial Crises*, National Bureau of Economic Research, Working Paper 14656 (Cambridge, MA: January 2009).

[24]Recessions mark a distinct phase of the overall business cycle, beginning with a business cycle "peak" and ending with a business cycle "trough." Between trough and peak the economy is in an expansion. The National Bureau of Economic Research identifies dates for national recessions, which can vary in overall duration and magnitude. The National Bureau of Economic Research is a private, nonprofit, nonpartisan research organization dedicated to promoting a greater understanding of how the economy works.

Figure 1: U.S. Real Gross Domestic Product in 2005 Dollars and Recession Periods, First Quarter 1947 through Third Quarter 2012



Source: GAO analysis of Bureau of Economic Analysis and National Bureau of Economic Research data.

Although the decline in the U.S. economy's real GDP during the recession may reflect some of the losses associated with the 2007-2009 financial crisis, the decline does not capture the cumulative losses from the crisis. To quantify the overall losses associated with past financial crises, researchers have estimated output losses as the cumulative shortfall between actual GDP and estimates of what GDP would have been if the crisis had not occurred. Measuring the shortfall in GDP in the aftermath of a crisis requires making a number of assumptions, and the measurement will vary depending on what assumptions are used. Figure 2 provides two examples to show how estimates of output losses vary depending on the assumptions used. The output shortfall is shown in the shaded areas of the two examples, with the output shortfall larger in example 2 than in example 1. Important assumptions include the following:

- **Start date of the crisis:** The first assumption involves selecting the date when the crisis began. The start date is shown as the vertical line

in examples 1 and 2 and is assumed to be the same. However, researchers have used different assumptions to select the start date of the 2007-2009 financial crisis.[25]

- **The path real GDP would have followed if the crisis had not occurred:** The second assumption involves estimating the counterfactual for the path of GDP—that is, the path that real GDP would have followed in the absence of a crisis.[26] This counterfactual is not observable. Studies have used different assumptions to estimate this path and one approach is to assume that this path would follow a precrisis trend in real GDP growth. For example, one study estimated trend output paths based on average GDP growth for the three years and ten years before the crisis. In figure 2, example 1 assumes a much lower (or less steep) trend rate of GDP growth than example 2. Assuming a higher growth trend results in a larger estimate of output losses.

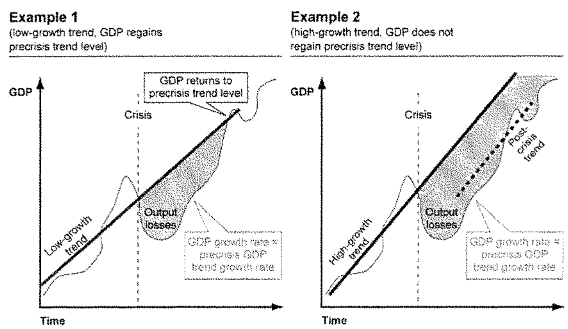
- **Projections of actual GDP:** The third assumption involves determining when GDP regained or will regain its estimated precrisis trend path. With respect to the recent crisis, some studies find that real GDP remains below the estimated precrisis trend. Researchers reach different conclusions about when or whether GDP will regain its long-term trend from before the crisis. Assumptions about the path of actual GDP and how it compares to the potential trend path can reflect different views on whether the output losses from the crisis are temporary or permanent. In contrast to example 1, where the economy regains its precrisis growth rate and level of output, example 2 assumes the economy regains its precrisis rate of output growth but remains permanently below the level of output projected by extrapolating the precrisis growth trend. As a result, output losses in example 2 extend farther into the future and are considerably larger

[25]Many researchers identify August 2007 as the start of the recent financial crisis, when strains appeared in interbank lending markets, but others date the start of the crisis to late 2008, when strains in credit markets intensified and led to the failure or near failure of a number of large financial institutions.

[26]Cecchetti et al. measure output losses by comparing postcrisis levels of GDP with the level of GDP at the onset of the crisis. However, this measure does not account for any growth in GDP that would have been expected to occur in the absence of a crisis. See Stephen G. Cecchetti, Marion Kohler, and Christian Upper, *Financial Crises and Economic activity*, National Bureau of Economic Research, Working Paper 15379 (Cambridge, MA: September 2009).

than in example 1. Some studies describe reasons why financial crises could be associated with permanent output losses. For example, sharp declines in investment during and following the crisis could result in lower capital accumulation in the long-term. In addition, persistent high unemployment could substantially erode the skills of many U.S. workers and reduce the productive capacity of the U.S. economy.

Figure 2: Examples Illustrating Sensitivity of Output Loss Estimates to Key Assumptions



Source: GAO presentation of figure from Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (Basel, Switzerland: August 2010).

Note: Example 2 assumes a higher trend rate of GDP growth than Example 1, resulting in a higher estimate of output losses (shown as the region shaded in grey). In example 1, GDP catches up with its precrisis path, while in example 2 GDP remains on a permanently lower path, albeit one with the same growth rate as that prevailing before the crisis.

Research suggests that U.S. output losses associated with the 2007-2009 financial crisis could range from several trillion to over $10 trillion. In January 2012, the Congressional Budget Office (CBO) estimated that the cumulative difference between actual GDP and estimated potential GDP

following the crisis would amount to $5.7 trillion by 2018.[27] CBO defined potential output as the output level that corresponds to a high rate of use of labor and capital. CBO reported that recessions following financial crises, like the most recent crisis, tend to reduce not only output below what it otherwise would have been but also the economy's potential to produce output, even after all resources are productively employed. In its estimate, CBO assumed that GDP would recover to its potential level by 2018, noting that it does not attempt to predict business cycle fluctuations so far into the future. Other studies have reported a wide range of estimates for the output losses associated with past financial crises, with some suggesting that output losses from the recent crisis could persist beyond 2018 or be permanent. In an August 2010 study, a working group of the Basel Committee on Banking Supervision reviewed the literature estimating output losses.[28] According to the Basel Committee working group's review, studies calculating long-term output losses relative to a benchmark (such as an estimated trend in the level of GDP) estimated much larger losses than studies calculating output losses over a shorter time period. In a June 2012 working paper, International Monetary Fund (IMF) economists estimated the cumulative percentage difference between actual and trend real GDP for the 4 years following the start of individual banking crises in many countries.[29] They found a median output loss of 23 percent of trend-level GDP for a historical set of banking crises and a loss of 31 percent for the 2007-2009 U.S. banking crisis. Other researchers who assume more persistent or permanent output losses

[27]CBO calculated this cumulative difference as the sum of the shortfall in output (compared to potential output) for each year that such a shortfall has occurred since the crisis began and the sum of projected shortfalls in the future—specifically, between its 2012 estimate date and 2018, when it projected that output would regain its potential level. See CBO, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, (Washington, D.C.: January 2012).

[28]Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements*, (Basel, Switzerland: August 2010). The Basel Committee on Banking Supervision (Basel Committee) seeks to improve the quality of banking supervision worldwide, in part by developing broad supervisory standards. The Basel Committee consists of central bank and regulatory officials from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The Basel Committee's supervisory standards are also often adopted by nonmember countries.

[29]Luc Laevan and Fabian Valencia, *Systemic Banking Crises Database: An Update*, IMF Working Paper, 12/163 (Washington, D.C.: June 2012).

from past financial crises estimate much larger output losses from these crises, potentially in excess of 100 percent of precrisis GDP.[30] While such findings were based on crisis events before 2007, if losses from the 2007-2009 crisis were to reach similar levels, the present value of cumulative output losses could exceed $13 trillion.

Studies that estimate output losses can be useful in showing the rough magnitude of the overall costs associated with the 2007-2009 financial crisis, but their results have limitations. Importantly, real GDP is an imperfect proxy of overall social welfare. As discussed below, real GDP measures do not reveal the distributional impacts of the crisis, and the costs associated with a financial crisis can fall disproportionately on certain populations. In addition, it is difficult to separate out the economic costs attributable to the crisis from the costs attributable to other factors, such as federal government policy decisions before, during, and after the crisis.

2007-2009 Crisis Was Also Associated with Large Declines in Employment, Household Wealth, and Other Economic Indicators

While studies often use output losses to measure the overall costs associated with financial crises, many researchers also discuss trends in unemployment, household wealth, and other economic indicators, such as the number of foreclosures, to provide a more granular picture of the effects of financial crises. As with trends in output losses, it is not possible to determine how much of the changes in these measures can be attributed to the financial crisis rather than to other factors. For example, analyzing the peak-to-trough changes in certain measures, such as home prices, can overstate the impacts associated with the crisis, as valuations before the crisis may have been inflated and unsustainable. The effects of the financial crisis have been wide-ranging, and we are not attempting to provide a comprehensive review of all components of the economic harm. Rather, the following highlights some of the most common types of measures used by academics and other researchers.

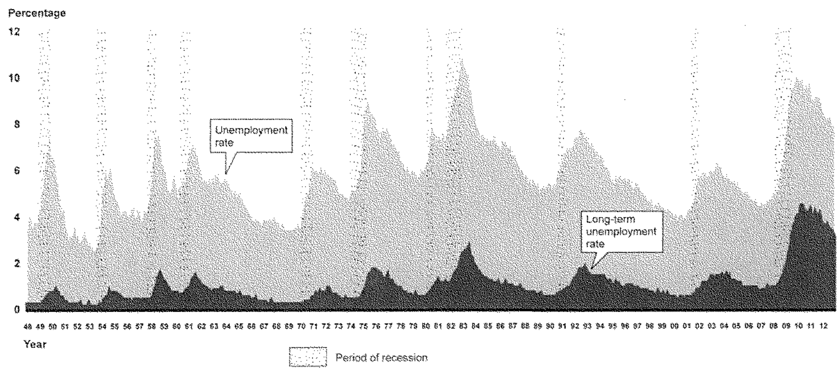
Unemployment

As shown in figure 3, the unemployment rate rose substantially following the onset of the financial crisis and then declined, but it remains above the historical average as of November 2012. The monthly unemployment rate peaked at around 10 percent in October 2009 and remained above 8

[30]See, for example, John H. Boyd, Sungkyu Kwak, and Bruce Smith, "The Real Output Losses Associated with Modern Banking Crises," *Journal of Money, Credit and Banking,* vol. 37, no. 6 (Dec. 2005), pp. 977-999.

percent for over 3 years, making this the longest stretch of unemployment above 8 percent in the United States since the Great Depression.[31] The monthly long-term unemployment rate—measured as the share of the unemployed who have been looking for work for more than 27 weeks—increased above 40 percent in December 2009 and remained above 40 percent as of November 2012.

Figure 3: National Unemployment Rate and Long-Term Unemployed as a Percentage of Labor Force, Seasonally Adjusted, and Recession Periods, 1948 through November 2012



Source: GAO presentation of Bureau of Labor Statistics data.

Persistent, high unemployment has a range of negative consequences for individuals and the economy. First, displaced workers—those who

[31]Persons considered to be marginally attached to the labor force and persons who were employed part time for economic reasons are not counted as unemployed persons in the Bureau of Labor Statistics' (BLS) calculation of the unemployment rate. BLS considers workers who want work and are available for work but who did not actively seek work in the past month as marginally attached to the labor force. BLS defines persons employed part time for economic reasons as those who want and are available for full-time work but have had to settle for a part-time schedule. As of November 2012, total unemployed persons plus these two groups—marginally attached persons and persons working part-time for economic reasons—represented 14.4 percent of the labor force plus those marginally attached to the labor force.

permanently lose their jobs through no fault of their own—often suffer an initial decline in earnings and also can suffer longer-term losses in earnings.[32] For example, one study found that workers displaced during the 1982 recession earned 20 percent less, on average, than their nondisplaced peers 15 to 20 years later.[33] Reasons that unemployment can reduce future employment and earnings prospects for individuals include the stigma that some employers attach to long-term unemployment and the skill erosion that can occur as individuals lose familiarity with technical aspects of their occupation. Second, research suggests that the unemployed tend to be physically and psychologically worse off than their employed counterparts. For example, a review of 104 empirical studies assessing the impact of unemployment found that people who lost their job were more likely than other workers to report having stress-related health conditions, such as depression, stroke, heart disease, or heart attacks.[34] Third, some studies find negative outcomes for health, earnings, and educational opportunities for the children of the unemployed. Fourth, periods of high unemployment can impact the lifetime earnings of people entering the workforce for the first time. For example, one study found that young people who graduate in a severe recession have lower lifetime earnings, on average, than those who graduate in normal economic conditions.[35] In prior work, we reported that long-term unemployment can have particularly serious consequences for older Americans (age 55 and over) as their job loss threatens not only their immediate financial security but also their ability to support

[32]Changes in workers' earnings provide a rough proxy for changes in their knowledge and skills obtained through education and experience—or what is referred to as their "human capital." The decline in earnings for some workers following the crisis could in part reflect other factors, such as their inability to continue working in an industry or occupation where employment has fallen as a result of changes in markets or technologies.

[33]Till von Wachter, Jae Song, and Joyce Manchester, "Long-term Earnings Losses Due to Mass Layoffs During the 1982 Recession: An Analysis Using U.S. Administrative Data from 1974 to 2004" (paper presented at the Institute for the Study of Labor / Centre for Economic Policy Research, 11th Symposium in Labour Economics in Buch, Ammersee, Sept. 17-19, 2009).

[34]McKee-Ryan et al., "Psychological and Physical Well-Being During Unemployment: A Meta-Analytic Study," *Journal of Applied Psychology*, vol. 90, no. 1 (January 2005), 53-76.

[35]Lisa B. Kahn, "The Long-Term Labor Market Consequences of Graduating from College in a Bad Economy," *Labour Economics*, vol. 17, no. 2 (Apr. 2010), 303-316.

themselves during retirement.[36] Persistent high unemployment can also increase budgetary pressures on federal, state, and local governments as expenditures on social welfare programs increase and individuals with reduced earnings pay less in taxes.

Household Wealth and Asset Prices

According to the Federal Reserve's Survey of Consumer Finances, median household net worth fell by $49,100 per family, or by nearly 39 percent, between 2007 and 2010. The survey found that this decline appeared to be driven most strongly by a broad collapse in home prices. Another major component of net worth that declined was the value of household financial assets, such as stocks and mutual funds. Economists we spoke with noted that precrisis asset prices may have reflected unsustainably high (or "bubble") valuations and it may not be appropriate to consider the full amount of the overall decline in net worth as a loss associated with the crisis. Nevertheless, dramatic declines in net worth, combined with an uncertain economic outlook and reduced job security, can cause consumers to reduce spending. Reduced consumption, all else equal, further reduces aggregate demand and real GDP.

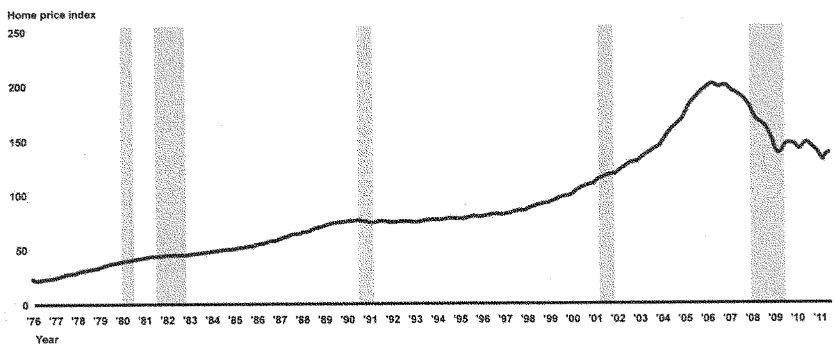
As we reported in June 2012, decreases in home prices played a central role in the crisis and home prices continue to be well below their peak nationwide.[37] According to CoreLogic's Home Price Index, home prices across the country fell nearly 29 percent between their peak in April 2006 and the end of the recession in June 2009 (see fig. 4).[38] This decline followed a 10-year period of significant home price growth, with the index more than doubling between April 1996 and 2006. Since 2009, home prices have fluctuated.

[36]GAO, *Unemployed Older Workers: Many Experience Challenges Regaining Employment and Face Reduced Retirement Security,* GAO-12-445 (Washington, D.C.: Apr. 25, 2012).

[37]GAO, *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts with Additional Data Collection and Analysis,* GAO-12-296 (Washington, D.C.: June 28, 2012).

[38]The CoreLogic Index, like other house price indexes, measures house price changes in a geographic area based on sales of the same properties at different points in time. The use of repeat transactions on the same homes helps to control for differences in the quality of the houses in the data. The CoreLogic index is based on all usable transactions from CoreLogic's public record, servicing, and securities databases of single family attached and detached homes with all types of financing, including prime and nonprime loans.

Figure 4: Home Prices and Recession Periods, January 1976 through June 2011



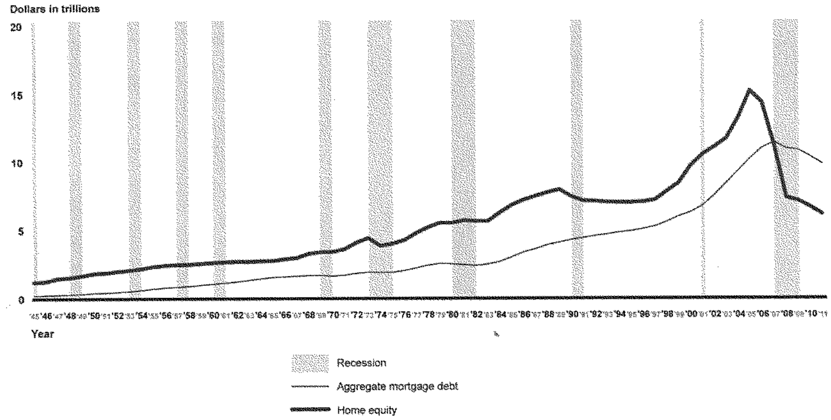
Source: CoreLogic Home Price Index, National Bureau of Economic Research.

Similarly, we also reported that homeowners have lost substantial equity in their homes, because home values have declined faster than home mortgage debt.[39] As shown in figure 5, households collectively lost about $9.1 trillion (in constant 2011 dollars) in national home equity between 2005 and 2011, in part because of the decline in home prices.[40] Figure 5 also shows that between 2006 and 2007, the steep decline in home values left homeowners collectively holding home mortgage debt in excess of the equity in their homes. This is the first time that aggregate home mortgage debt exceeded home equity since the data were kept in 1945. As of December 2011, national home equity was approximately $3.7 trillion less than total home mortgage debt.

[39] See GAO-12-296.

[40] National home equity is the difference between aggregate home value and aggregate home mortgage debt, which is a measure of the value of household-owned real estate debt.

Figure 5: Value of Home Equity and Aggregate Mortgage Debt and Recession Periods, 1945 through 2011

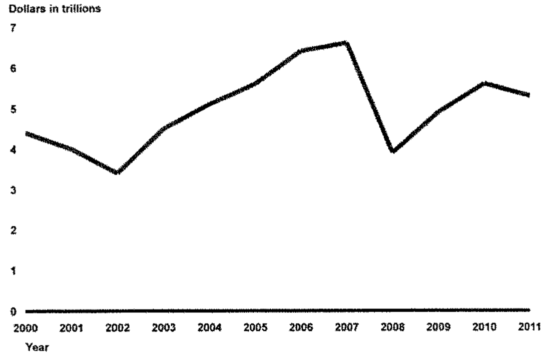


Source: Federal Reserve, Flow of Funds Accounts of the United States; Bureau of Labor Statistics; and National Bureau of Economic Research.

Note: In 2011 constant dollars.

Declines in the value of household investments in stocks and mutual funds also contributed to significant declines in household wealth after the crisis began. In addition to experiencing a decline in the value of their stock and mutual fund investments, households also experienced a decline in their retirement funds. As shown in figure 6, the value of corporate equities held in retirement funds dropped sharply in late 2008. While equity prices and the value of retirement fund assets generally have recovered since 2009, investors and pension funds that sold assets at depressed prices experienced losses. For example, officials from a large pension fund told us that they were forced to sell equity securities at depressed prices during the crisis to meet their liquidity needs. Experts have different views on how the crisis may have changed investors' attitudes towards risk-taking. To the extent that investors are more risk averse and demand higher returns for the risks associated with certain investments, businesses could face increased funding costs that could contribute to slower growth.

Figure 6: Aggregate Value of Corporate Equities Held in Retirement Funds, December 31, 2000, through December 31, 2011



Source: GAO analysis of Federal Reserve Board Flow of Funds data.

Note: This figure includes corporate equities held directly or indirectly through private pension funds and federal, state, and local retirement funds.

Foreclosures

In 2006, the percentage of loans in default or in foreclosure began to increase (see fig. 7).[41] As we previously reported, a number of factors contributed to the increase in loan defaults and foreclosures, including a rapid decline in home prices throughout much of the nation and weak regional labor market conditions in some states where foreclosure rates were already elevated.[42] During the 2007-2009 recession, the elevated unemployment rate and declining home prices worsened the financial circumstances for many families, along with their ability to make their mortgage payments. Foreclosures have been associated with a number

[41]Foreclosure is a legal process that a mortgage lender initiates against a homeowner who has missed a certain number of payments. The foreclosure process has several possible outcomes but generally means that the homeowner loses the property, typically because it is sold to repay the outstanding debt or repossessed by the lender. The legal fees, foregone interest, property taxes, repayment of former homeowners' delinquent obligations, and selling expenses can make foreclosure extremely costly to lenders.

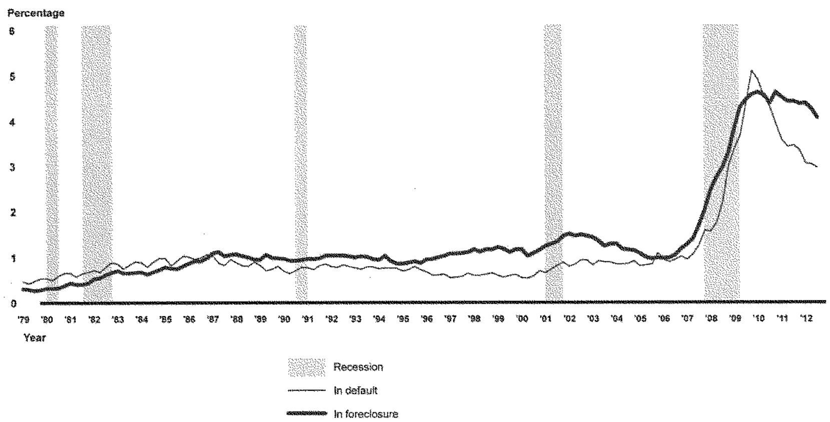
[42]See GAO-12-296.

of adverse effects on homeowners, communities, the housing market, and the overall economy. Homeowners involved in a foreclosure often are forced to move out and may see their credit ratings plummet, making it difficult to purchase another home. A large number of foreclosures can have serious consequences for neighborhoods.[43] For example, research has shown that foreclosures depress the values of nearby properties in the local neighborhood.[44] Creditors, investors, and servicers can incur a number of costs during the foreclosure process (e.g., maintenance and local taxes) and a net loss, if there is a shortfall between the ultimate sales price and the mortgage balance and carrying costs. Large numbers of foreclosures can significantly worsen cities' fiscal circumstances, both by reducing property tax revenues and by raising costs to the local government associated with maintaining vacant and abandoned properties.

[43]See, for example, GAO, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges,* GAO-12-34 (Washington, D.C.: Nov. 4, 2011).

[44]See, for example, Brian A. Mikelbank, "Spatial Analysis of the Impact of Vacant, Abandoned and Foreclosed Properties," study conducted for the Office of Community Affairs, Federal Reserve Bank of Cleveland, 2008; and Kai-yan Lee, "Foreclosure's Price-Depressing Spillover Effects on Local Properties: A Literature Review" (Community Affairs Discussion Paper, Federal Reserve Bank of Boston, 2008).

Figure 7: Percentage of Loans in Default 90 Days or More or in Foreclosure and Recession Periods, March 1979 through September 2012



Source: Mortgage Bankers Association; National Bureau of Economic Research.

Federal, State, and Local Governments Have Faced Increased Fiscal Challenges Since the Start of the 2007-2009 Financial Crisis

Some studies consider measures of fiscal costs—such as increases in federal government debt—when analyzing the losses associated with financial crises. Like past financial crises, the 2007-2009 financial crisis has been associated with large increases in the federal government's debt and heightened fiscal challenges for many state and local governments. Factors contributing to these challenges include decreased tax revenues from reduced economic activity and increased spending associated with government efforts to mitigate the effects of the recession.

Federal Government's Fiscal Challenges

In prior work, we have reported that the economic downturn and the federal government's response caused budget deficits to rise in recent years to levels not seen since World War II.[45] While the structural imbalance between spending and revenue paths in the federal budget predated the financial crisis, the size and urgency of the federal government's long-term fiscal challenges increased significantly following the crisis's onset. From the end of 2007 to the end of 2010, federal debt held by the public increased from roughly 36 percent of GDP to roughly 62 percent. Key factors contributing to increased deficit and debt levels following the crisis included (1) reduced tax revenues, in part driven by declines in taxable income for consumers and businesses; (2) increased spending on unemployment insurance and other nondiscretionary programs that provide assistance to individuals impacted by the recession; (3) fiscal stimulus programs enacted by Congress to mitigate the recession, such as the American Recovery and Reinvestment Act of 2009 (Recovery Act);[46] and (4) increased government assistance to stabilize financial institutions and markets.

While deficits during or shortly after a recession can support an economic recovery, increased deficit and debt levels could have negative effects on economic growth. For example, rising federal debt can "crowd out" private investment in productive capital as the portion of savings that is used to buy government debt securities is not available to fund such investment. Lower levels of private investment can reduce future economic growth. In

[45]GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2011 Update*, GAO-11-451SP (Washington, D.C.: Mar. 18, 2011). For the most recent update, see GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2012 Update*, GAO-13-148SP (Washington, D.C.: Dec. 3, 2012).

[46]Pub. L. No. 111-5, 123 Stat. 115 (2009). The federal government's largest response to the recession to date came in early 2009 with the passage of the Recovery Act. Fiscal stimulus programs are intended to increase aggregate demand—the spending of consumers, business firms, and governments—and may be either automatic or discretionary. Unemployment insurance, the progressive aspects of the tax code, and other fiscal stabilizers provide stimulus automatically by easing pressure on household incomes as economic conditions deteriorate. Discretionary fiscal stimulus, such as that provided by the Recovery Act, can take the form of tax cuts for households and businesses, transfers to individuals, grants-in-aid to state and local governments, or direct federal spending. In response, households, businesses, and governments may purchase more goods and services than they would have otherwise, and governments and businesses may refrain from planned workforce cuts or even hire additional workers. Thus, fiscal stimulus may lead to an overall, net increase in national employment and output.

addition, increased debt increases the amount of interest the government pays to its lenders, all else equal. Policy alternatives to offsetting increased interest payments include increasing tax rates and reducing government benefits and services, which also can reduce economic growth. Moreover, increased fiscal challenges could make the United States more vulnerable to a fiscal crisis should investors lose confidence in the ability of the U.S. government to repay its debts. Such a crisis could carry enormous costs because the federal government would face a sharp increase in its borrowing costs.

The following discussion focuses on the costs associated with the federal government's actions to assist the financial sector. Fiscal stimulus programs, such as the Recovery Act, and the Federal Reserve's monetary policy operations were major components of the federal government's efforts to mitigate the recession that coincided with the 2007-2009 financial crisis. However, given our focus on the Dodd-Frank Act reforms, the potential short-term and long-term impacts of these efforts are beyond the scope of this report. Furthermore, our review did not consider the benefits or costs of government policy interventions relative to alternatives that were not implemented.

With respect to the most significant government programs and other actions to assist the financial sector, the following discussion reviews (1) expert perspectives on how these policy responses could have reduced or increased the severity of the financial crisis and the associated economic losses; (2) the potential costs associated with increased moral hazard; and (3) the financial performance (including income and losses) of the largest of these policy interventions.

Federal financial regulators and several academics and other experts we spoke with highlighted several interventions that they maintain likely helped to mitigate the severity of the 2007-2009 financial crisis. These interventions included

- providing emergency funding to support several key credit markets through the Federal Reserve's emergency credit and liquidity programs;[47]

[47] For more information about these emergency programs, see GAO, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance*, GAO-11-696 (Washington, D.C.: July 21, 2011).

- extending federal government guarantees to a broader range of private sector liabilities through FDIC's Temporary Liquidity Guarantee Program (TLGP) and Treasury's Money Market Fund Guarantee Program;
- recapitalizing financial firms through Treasury's Troubled Asset Relief Program's Capital Purchase Program; and
- taking actions with respect to individual firms, such as Fannie Mae, Freddie Mac, American International Group (AIG), Citigroup, and Bank of America, to avert further destabilization of financial markets.

Many experts maintain that these large-scale interventions, in combination with other government actions, such as the stress tests, helped to restore confidence in the financial system and bring about a recovery in certain private credit markets in 2009.[48] In contrast, other experts argue that certain federal government actions worsened, rather than mitigated, the severity of the financial crisis. For example, some experts maintain that the federal government's rescue of Bear Stearns but not Lehman Brothers sent a conflicting signal to the market and contributed to a more severe panic. Some experts also have commented that government assistance to the financial and housing sectors may have slowed the economic recovery by preventing a full correction of asset prices. Many experts agree that several (if not all) of the federal government's policy interventions likely averted a more severe crisis in the short-run and that the long-term implications of these interventions remain to be seen.

Experts generally agree that the government actions to assist the financial sector may have increased moral hazard—that is, such actions may have encouraged market participants to expect similar emergency actions in the future, thus weakening private incentives to properly manage risks and creating the perception that some firms are too big to fail. Increased moral hazard could result in future costs for the

[48]In February 2009, to help restore confidence in the financial system, Treasury announced the Financial Stability Plan, which established the Supervisory Capital Assessment Program (SCAP). SCAP, as implemented by the Federal Reserve and other federal banking regulators, was to determine through a stress test whether the largest 19 U.S. bank holding companies had enough capital for the next 2 years (2009-2010) to support their lending activities and survive a second similar economic shock. For more information about the stress tests, see GAO, *Troubled Asset Relief Program: Bank Stress Test Offers Lessons as Regulators Take Further Actions to Strengthen Supervisory Oversight*, GAO-10-861 (Washington, D.C.: Sept. 29, 2010).

government if reduced private sector incentives to manage risks contribute to a future financial crisis.

Although the financial performance of the federal government's assistance to the financial sector can be measured in different ways, most of the federal government's major programs earned accounting income in excess of accounting losses and the net losses for some interventions are expected to be small relative to the overall increase in the federal debt.[49] For example, the Federal Reserve reported that all loans made under its emergency programs that have closed were repaid with interest and does not project any losses on remaining loans outstanding. Under FDIC's TLGP, program participants, which included insured depository institutions and their holding companies, paid fees on debt and deposits guaranteed by the program; these fees created a pool of funds to absorb losses. According to FDIC data, as of November 30, 2012, FDIC had collected $11.5 billion in TLGP fees and surcharges, and this amount is expected to exceed the losses from the program.[50] In contrast, Treasury's investments in Fannie Mae and Freddie Mac under the Senior Preferred Stock Purchase Agreements program represent the federal government's single largest risk exposure remaining from its emergency actions to assist the financial sector.[51] Cumulative cash draws by the GSEs under this program totaled $187.4 billion as of September 30, 2012, and Treasury reported a contingent liability of $316.2 billion for this program as of September 30, 2011.[52] As of September 30, 2012, Fannie Mae and

[49]Between September 30, 2007, and September 30, 2011, the gross federal debt increased by about $7.1 trillion. In comparison, Fannie Mae and Freddie Mac's cumulative cash draws (net of dividends paid on these draws) under Treasury's Senior Preferred Stock Purchase Agreements program stood at approximately $137 billion as of September 30, 2012. Some academic studies that review the costs of financial crises have found that costs associated with rescuing financial institutions are generally small relative to overall crisis costs. See, for example, Reinhart and Rogoff (2009).

[50]As of December 31, 2011, FDIC estimated losses of $2.2 billion on TLGP guarantees of deposits and reported that it had paid or accrued $152 million in estimated losses resulting from TLGP debt guarantees.

[51]Under the Senior Preferred Stock Purchase Agreements program, Treasury has made funding advances to Fannie Mae and Freddie Mac to ensure that they have sufficient assets to support their liabilities.

[52]This accrued contingent liability is based on the projected draws from Treasury under the Senior Preferred Stock Purchase Agreements program. It is undiscounted and does not take into account any of the offsetting dividends which may be received as a result of those draws.

Freddie Mac had paid Treasury a total of $50.4 billion in dividends on these investments.[53] The amount that Treasury will recoup from these investments is uncertain. Table 2 provides an overview of income and losses from selected federal government interventions to assist the financial sector.

Table 2: Overview of Income and Losses for Selected Federal Government Interventions to Assist the Financial Sector during the 2007-2009 Financial Crisis

Program or Type of Assistance	Dollar Amount	Accounting Income / Losses
Programs with Broad-Based Eligibility		
Federal Reserve System's emergency credit and liquidity programs[a]	> $1 trillion peak loans outstanding[b]	Approximately $19.7 billion in gross interest and fee income as of June 30, 2012, according to estimates published on the Federal Reserve Bank of New York's (FRBNY) website.[c] The Federal Reserve has reported no losses on the programs that have closed. FRBNY projects that the remaining facility with loans outstanding will not incur losses.
FDIC's Temporary Liquidity Guarantee Program		Over $11 billion in total fee income is expected to exceed projected losses of around $2.4 billion.
• Debt Guarantee Program (DGP)	Approx. $345.8 billion (peak debt guaranteed)	All debt guaranteed by DGP was scheduled to mature by the end of 2012. FDIC collected $10.4 billion in DGP income from fees and surcharges. As of Dec. 31, 2011, FDIC reported estimated DGP losses of $152 million and projected that it would pay $682 thousand in interest payments on defaulting DGP-guaranteed notes in 2012.
• Transaction Account Guarantee Program (TAGP)	Approx. $834.5 billion (peak deposits guaranteed)	TAGP closed on Dec. 31, 2010. FDIC collected $1.2 billion in fees. Cumulative estimated losses totaled $2.2 billion as of Dec. 31, 2011.
Treasury's Guarantee Program for Money Market Funds	> $3 trillion money market fund shares guaranteed at $1 per share	$1.2 billion of fee income and no losses. The program closed on Sept. 18, 2009.
Treasury's Capital Purchase Program (CPP)[d]	$204.9 billion disbursed	As of Oct. 31, 2012, Treasury had received almost $220 billion from its CPP investments, exceeding the $204.9 billion it disbursed. Of that disbursed amount, $8.3 billion remained outstanding as of Oct. 31, 2012. As of Sept. 30, 2012, Treasury estimated that CPP would have a lifetime income of approximately $14.9 billion after all institutions exit the program.

[53]Under the current terms of the Senior Preferred Stock Purchase Agreements program, Fannie Mae and Freddie Mac must pay out all of their quarterly profits (if any) to Treasury.

Program or Type of Assistance	Dollar Amount	Accounting Income / Losses
Assistance to Individual Institutions		
Fannie Mae and Freddie Mac (Treasury)	$187.4 billion drawn from Treasury as of Sept. 30, 2012	$316.2 billion contingent liability reported as of Sept. 30, 2011, which is based on the value of projected investments in the GSEs as of this date.
American International Group, Inc. (AIG) (Treasury and Federal Reserve System)[e]	$182 billion peak commitment by Treasury and FRBNY	$17.7 billion total net profit on all FRBNY assistance to AIG. FRBNY was repaid in full on all loans it provided to assist AIG. Treasury's preferred stock investments of $20.3 billion were fully repaid with interest income of $0.9 billion. Treasury's sales of all of its AIG common stock have yielded total proceeds of about $51.6 billion. Together with its preferred stock investments in AIG, Treasury has recouped the total value of its assistance extended to AIG with a net gain of $5.0 billion.
Assistance to Bank of America Corporation and Citigroup, Inc. (Treasury, FDIC, and Federal Reserve System)	$40 billion in additional capital ($20 billion for each firm) and agreements with regulators to protect against larger-than-expected losses on asset portfolios	$4.0 billion in net income earned by Treasury on its investments in Bank of America Corporation and Citigroup, Inc. under its Targeted Investment Program. Bank of America Corporation and Citigroup, Inc. paid fees of $425 million and $50 million, respectively, to federal government parties to terminate the loss sharing agreements, and government parties received $5.3 billion in Citigroup preferred stock.

Source: GAO presentation of information from FDIC, Federal Reserve System, and Treasury documents.

Note: The financial performance of these programs can be measured in different ways. Accounting measures of financial performance have limitations. For example, they do not capture information about whether the interest, dividend, or other income the federal government received provided appropriate compensation for the risks it assumed.

[a] The Federal Reserve System consists of the Board of Governors of the Federal Reserve System (Federal Reserve)—a federal agency—and 12 regional Reserve Banks. The Federal Reserve Bank of New York operated most of the Federal Reserve System's emergency programs. For more information about these emergency programs, see GAO, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance*, GAO-11-696 (Washington, D.C.: July 21, 2011).

[b] Total lending under these emergency programs peaked at over $1 trillion in December 2008.

[c] This estimate includes income from the broad-based emergency programs authorized under Section 13(3) of the Federal Reserve Act, the Term Auction Facility, and the swap lines with foreign central banks. See Fleming, "Federal Reserve Liquidity Facilities Gross $22 Billion for U.S. Taxpayers", accessed December 17, 2012, http://libertystreeteconomics.newyorkfed.org/2012/11/federal-reserve-liquidity-facilities-gross-22-billion-for-us-taxpayers.html.

[d] Created in 2008, the Capital Purchase Program was the primary initiative under the Troubled Asset Relief Program to help stabilize the financial markets and banking system by providing capital to qualifying regulated financial institutions through the purchase of senior preferred shares and subordinated debt.

[e] For more information about the assistance to AIG, see GAO, *Troubled Asset Relief Program: Government's Exposure to AIG Lessens as Equity Investments Are Sold*, GAO-12-574 (Washington, D.C.: May 7, 2012).

State and Local Governments

In our prior work, we have described how the national recession that coincided with the 2007-2009 financial crisis added to the fiscal challenges facing the state and local sectors.[54] Declines in output, income, and employment caused state and local governments to collect less revenue at the same time that demand for social welfare services they provide was increasing. During the most recent recession, state and local governments experienced more severe and long-lasting declines in revenue than in past recessions. Because state governments typically face balanced budget requirements and other constraints, they adjust to this situation by raising taxes, cutting programs and services, or drawing down reserve funds, all but the last of which amplify short-term recessionary pressure on households and businesses. Local governments may make similar adjustments, unless they can borrow to make up for reduced revenue. The extent to which state and local governments took such actions was impacted by the federal government's policy responses to moderate the downturn and restore economic growth. Under the Recovery Act, the federal government provided $282 billion in direct assistance to state and local governments to help offset significant declines in tax revenues.

States have been affected differently by the 2007-2009 recession. For example, the unemployment rate in individual states increased by between 1.4 and 6.8 percentage points during the recession. Recent economic research suggests that while economic downturns within states generally occur around the same time as national recessions, their timing and duration vary. States' differing characteristics, such as industrial structure, contribute to these differences in economic activity.

Declines in state and local pension asset values stemming from the 2007-2009 recession also could affect the sector's long-term fiscal position. In March 2012, we reported that while most state and local government pension plans had assets sufficient to cover benefit payments to retirees for a decade or more, plans have experienced a growing gap between assets and liabilities.[55] In response, state and local governments have

[54]GAO, *State and Local Governments: Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance,* GAO-11-401 (Washington, D.C.: Mar. 31, 2011).

[55]GAO, *State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability,* GAO-12-322 (Washington, D.C.: Mar. 2, 2012).

begun taking a number of steps to manage their pension obligations, including reducing benefits and increasing member contributions.

The Dodd-Frank Act May Enhance Financial Stability and Provide Other Benefits, with the Extent of the Benefits Depending on a Number of Factors

The Dodd-Frank Act contains several provisions that may benefit the financial system and the broader economy, but the realization of such benefits depends on a number of factors. Our review of the literature and discussions with a broad range of financial market regulators, participants, and observers revealed no clear consensus on the extent to which, if at all, the Dodd-Frank Act will help reduce the probability or severity of a future crisis. Nevertheless, many of these experts identified a number of the same reforms that they expect to enhance financial stability, at least in principle, and help reduce the probability or severity of a future crisis. At the same time, such experts generally noted that the benefits are not assured and depend on, among other things, how regulators implement the provisions and whether the additional regulations result in financial activity moving to less regulated institutions or markets. Several experts also commented that the act also could enhance consumer and investor protections. While estimating the extent to which the act may reduce the probability of a future crisis is difficult and subject to limitations, studies have found statistical evidence suggesting that certain reforms are associated with a reduction in the probability of a crisis.

Several Dodd-Frank Provisions May Help Reduce the Probability or Severity of a Future Crisis, but Uncertainty Exists about Their Effectiveness

Through our review of the literature and discussions with a broad range of financial market regulators, academics, and industry and public interest group experts, we found no clear consensus on the extent to which, if at all, the Dodd-Frank Act will help reduce the probability or severity of a future financial crisis. However, representatives of these groups identified many of the same provisions in the act that they expect to enhance financial stability, at least in principle, and help reduce the probability or severity of a future crisis. These provisions include the following:

- **Creation of FSOC and OFR:** The act created FSOC and OFR to monitor and address threats to financial stability.
- **Heightened prudential standards for systemically important financial institutions (SIFI):** The act requires that all SIFIs be subjected to Federal Reserve supervision and enhanced capital and other prudential standards. SIFIs include bank holding companies with

$50 billion or more in total consolidated assets and nonbank financial companies designated by FSOC for such supervision.[56]

- **Orderly Liquidation Authority:** The act provides regulators with new authorities and tools to manage the failure of a large financial company in a way designed to avoid taxpayer-funded bailouts and mitigate the potential for such failures to threaten the stability of the financial system.
- **Regulation of swaps:** The act establishes a comprehensive regulatory framework for swaps.
- **Mortgage-related and other reforms:** The act includes provisions to modify certain mortgage lending practices, increase regulation of asset-backed securitizations, and restrict proprietary trading by large depository institutions.

Experts had differing views on these provisions, but many expect some or all of the provisions to improve the financial system's resilience to shocks and reduce incentives for financial institutions to take excessive risks that could threaten the broader economy. While acknowledging these potential financial stability benefits, experts generally were cautious in their assessments for several reasons. Specifically, the effectiveness of certain provisions will depend not only on how regulators implement the provisions through rulemaking or exercise their new authorities but also on how financial firms react to the new rules, including whether currently regulated financial activity migrates to less regulated institutions or markets. In addition, a few experts with whom we spoke said that some of the act's provisions could increase systemic risk and, thus, have adverse

[56]While the Dodd-Frank Act does not use the term "systemically important financial institution," this term is commonly used by academics and other experts to refer to bank holding companies with $50 billion or more in total consolidated assets and nonbank financial companies designated by FSOC for Federal Reserve supervision and enhanced prudential standards.

effects on financial stability.[57] Further, it may be neither possible nor necessarily desirable for the Dodd-Frank Act or any other legislation to prevent all future financial crises, in part because of the tradeoff inherent between financial stability and economic growth.

Creation of FSOC and OFR to Monitor and Address Threats to Financial Stability

The 2007-2009 financial crisis highlighted the lack of an agency or mechanism responsible for monitoring and addressing risks across the financial system and a shortage of readily available information to facilitate that oversight.[58] We reported in July 2009 that creating a new body or designating one or more existing regulators with the responsibility to oversee systemic risk could serve to address a significant gap in the current U.S. regulatory system.[59] Before the Dodd-Frank Act's passage, federal financial regulators focused their oversight more on individual financial firms (called microprudential regulation) and less on market stability and systemic risk (called macroprudential regulation). However, the recent crisis illustrated the potential for one financial firm's distress to spill over into the broader financial system and economy. For example, the failures and near-failures of Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and other large financial institutions contributed to the instability experienced in the financial system during the crisis. The crisis also illustrated the potential for systemic risk to be generated and propagated outside of the largest financial firms (such as by money market mutual funds), in part because of interconnections not only

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[57]In our March 2009 testimony on credit default swaps, we noted that no single definition for systemic risk exists. Traditionally, systemic risk has been viewed as the risk that the failure of one large institution would cause other institutions to fail. This micro-level definition is one way to think about systemic risk. Recent events have illustrated a more macro-level definition: the risk that an event could broadly affect the financial system rather than just one or a few institutions. *See* GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T (Washington, D.C.: Mar. 5, 2009).

[58]See, for example, Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009).

[59]See GAO, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System*, GAO-09-739 (Washington, D.C.: July 22, 2009).

between firms but also between markets.[60] According to some academics and other market observers, a significant market failure revealed by the recent crisis was that the market did not discourage individual financial firms from taking excessive risks that could impose costs on others, including the public.[61] Such spillover costs imposed on others are known as negative externalities, and government intervention may be appropriate to address such externalities.

The Dodd-Frank Act established FSOC to provide, for the first time, an entity charged with the responsibility for monitoring and addressing sources of systemic risk.[62] The act also created OFR to support FSOC and Congress by providing financial research and data.[63] FSOC is authorized, among other things, to

- collect information across the financial system from member agencies and other government agencies, so that regulators will be better prepared to address emerging threats;

[60]Money market mutual funds (MMMF) are mutual funds that are registered under the Investment Company Act of 1940, and regulated under rule 2a-7 under that act. In September 2008, following the failure of Lehman Brothers Inc., many MMMFs faced severe liquidity pressures as redemption requests from their investors increased significantly. Many MMMF investors became concerned about potential losses on their investments when they learned that the Reserve Primary Money Fund, a large MMMF that suffered losses on holdings of Lehman Brothers commercial paper, "broke the buck"—that is, the net asset value of the fund dropped below its target value of $1 per share. Regulators became concerned that these pressures on MMMFs could further exacerbate turmoil in the markets. The potential widespread failure of MMMFs threatened systemic financial stability, as these funds were significant investors in many money market instruments, such as financial and nonfinancial commercial paper, floating rate notes, and CDs. Accordingly, regulators feared that a failure of the MMMF industry could have serious repercussions on other institutions and overall credit market conditions, as many businesses and investment vehicles would have had difficulty rolling over their liabilities and potentially been unable to finance their operations. Treasury and the Federal Reserve created temporary programs to assist MMMFs and reduce the likelihood that these funds would reduce their purchases of money market instruments issued by financial institutions.

[61]See, for example, Viral V. Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* (Hoboken, NJ: John Wiley & Sons, Inc., 2011).

[62]The provisions of the Dodd-Frank Act dealing with FSOC are contained primarily in subtitle A of title I, §§ 111–123, *codified* at 12 U.S.C. §§ 5321–5333 and title VIII, codified at 12 U.S.C. §§ 5461–5472.

[63]The provisions of the Dodd-Frank Act dealing with OFR are contained primarily in subtitle B of title I, §§ 151–156, *codified* at 12 U.S.C. §§ 5341–5346.

- designate certain nonbank financial companies for supervision by the Federal Reserve and subject them to enhanced prudential standards;
- designate as systemically important certain financial market utilities and payment, clearing, or settlement activities, and subject them to enhanced regulatory oversight;
- recommend stricter standards for the large, interconnected bank holding companies and nonbank financial companies designated for enhanced supervision;
- vote on any determination by the Federal Reserve that action should be taken to break up a SIFI that poses a "grave threat" to U.S. financial stability;
- facilitate information sharing and coordination among the member agencies to eliminate gaps in the regulatory structure; and
- make recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, promote market discipline, and maintain investor confidence.

Financial market regulators, academics, and industry and public interest groups with whom we spoke generally view the creation of FSOC and OFR as positive steps, in principle, to address systemic risk and help identify or mitigate a future crisis for several reasons. First, FSOC and its member agencies now have explicit responsibility for taking a macroprudential approach to regulation, along with tools and authority to help identify and address threats to the financial stability of the United States. For example, certain nonbank financial companies posed systemic risk during the crisis but were subject to less regulation than bank holding companies. To close this regulatory gap, FSOC has the authority to designate a nonbank financial company for supervision by the Federal Reserve and subject it to enhanced prudential standards, if the material distress of that firm could pose a risk to U.S. financial stability.[64] In addition, although the Dodd-Frank Act does not address all sources of systemic risk, the act authorizes FSOC to make recommendations to

[64]As we previously reported, the act provided that FSOC may determine whether a nonbank financial company shall be supervised by the Federal Reserve and subject to prudential standards if it determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States. The act lists specific factors for FSOC to consider in making these determinations along with any other risk-related factors it deems appropriate. Bank holding companies with $50 billion or more in total consolidated assets are automatically subject to the Federal Reserve's enhanced supervision and prudential standards. See GAO-12-886 and 77 Fed. Reg. 21,637 (Apr. 11, 2012).

address regulatory gaps or other issues that threaten U.S. financial stability. For example, FSOC's 2011 and 2012 annual reports discuss financial stability threats not directly addressed by the Dodd-Frank Act (e.g., money market mutual funds, tri-party repurchase agreements, and the GSEs) and make recommendations to address some of them.[65] Finally, OFR may play an important role in gathering and analyzing data that FSOC and its members will be able to use to identify and address emerging risks to the financial system. OFR may also facilitate data sharing among the regulators, which may enable regulators to identify risks in areas emerging from beyond their immediate jurisdictions. Market participants also may benefit from the ability to use OFR data to analyze risks.

Experts also identified a number of factors that could limit FSOC's or OFR's effectiveness. First, it is inherently challenging for a regulator to identify and address certain sources of systemic risk. For example, while asset price bubbles often become clear in hindsight, when such risks appear to be building, policymakers may disagree over whether any intervention is warranted. Second, FSOC's committee structure cannot fully resolve the difficulties inherent in the existing, fragmented regulatory structure. For example, FSOC could encounter difficulties coming to decisions or advancing a reform if it faces resistance from one or more of its members. In addition, FSOC's committee structure, including the Treasury Secretary's role as FSOC chair, could subject FSOC's decision making to political influence. According to a number of experts, establishing FSOC and OFR as independent entities could have better insulated them from political pressures that could dissuade them from recommending or taking actions to promote long-term financial stability, if such actions imposed short-term political costs. On the other hand, the selection of the Treasury Secretary as FSOC chair reflects the Treasury Secretary's traditional role in financial policy decisions.

In a recent report, we identified a number of potential challenges for FSOC, some of which are similar to those discussed above.[66] Specifically, we noted that key components of FSOC's mission—to identify risks to U.S. financial stability and respond to emerging threats to stability—are

[65]Financial Stability Oversight Council, *Annual Report*, 2011 and 2012 (Washington, D.C.: July 2011 and July 2012).

[66]See GAO-12-886.

inherently challenging. Risks to the stability of the U.S. financial system are difficult to identify because commonly used indicators, such as market prices, often do not reflect these risks and threats may not develop in precisely the same way as they did in past crises. Although the act created FSOC to provide for a more comprehensive view of threats to U.S. financial stability, it left most of the pre-existing fragmented and complex arrangement of independent federal and state regulators in place and generally preserved their statutory responsibilities. Further, we noted that FSOC does not have the authority to force agencies to coordinate or adopt compatible policies and procedures. However, we also reported that FSOC and OFR have made progress in establishing their operations and approaches for monitoring threats to financial stability, but these efforts could be strengthened. We made recommendations to strengthen the accountability and transparency of FSOC's and OFR's decisions and activities as well as to enhance collaboration among FSOC members and with external stakeholders. In response to our recommendations, Treasury emphasized the progress that FSOC and OFR have made since their creation and noted that more work remains, as they are relatively new organizations.

Heightened Capital and Other Prudential Standards for SIFIs

The 2007-2009 financial crisis also revealed weaknesses in the existing regulatory framework for overseeing large, interconnected, and highly leveraged financial institutions. Such financial firms were subject to some form of federal supervision and regulation, but these forms of supervision and regulation proved inadequate and inconsistent. For example, fragmentation of supervisory responsibility allowed owners of banks and other insured depository institutions to choose their own regulator. In addition, regulators did not require firms to hold sufficient capital to cover their trading and other losses or to plan for a scenario in which liquidity was sharply curtailed. Moreover, the regulatory framework did not ensure that banks fully internalized the costs of the risks that their failure could impose on the financial system and broader economy.

The Dodd-Frank Act requires the Federal Reserve to supervise and develop enhanced capital and other prudential standards for SIFIs, which include bank holding companies with $50 billion or more in consolidated assets and any nonbank financial company that FSOC designates.[67] The act requires the enhanced prudential standards to be more stringent than

[67] Dodd-Frank Act, § 165, 124 Stat. at 1423–1432, *codified at* 12 U.S.C. § 5365.

standards applicable to other bank holding companies and financial firms that do not present similar risks to U.S. financial stability. The act further allows the enhanced standards to increase in stringency based on the systemic footprint and risk characteristics of each firm. The Federal Reserve plans to implement some of its enhanced standards in conjunction with its implementation of Basel III, a new capital regime developed by the Basel Committee on Banking Supervision.[68] The act's provisions related to SIFIs include the following:

- **Risk-based capital requirements and leverage limits:** The Federal Reserve must establish capital and leverage standards, which as proposed would include a requirement for SIFIs to develop capital plans to help ensure that they maintain capital ratios above specified standards, under both normal and adverse conditions. In addition, the Federal Reserve has announced its intention to apply capital surcharges to some or all SIFIs based on the risks SIFIs pose to the financial system.
- **Liquidity requirements:** The Federal Reserve must establish SIFI liquidity standards, which as proposed would include requirements for SIFIs to hold liquid assets that can be used to cover their cash outflows over short time periods.
- **Single-counterparty credit limits:** The Federal Reserve must propose rules that, in general, limit the total net credit exposure of a

[68]The Federal Reserve intends to satisfy some aspects of the Dodd-Frank Act heightened prudential standards rules for bank SIFIs through implementation of the Basel Committee on Banking Supervision standards. The Basel Committee has developed international standards for bank capital for its member economies since the 1980s. The United States, along with nearly all other major economies, agree to comply with international capital standards. Over the past few years, U.S. federal banking regulators have worked with other members of the Basel Committee to strengthen the regulatory capital regime for internationally active banks and develop a framework for a risk-based capital surcharge for the world's largest, most interconnected banking companies. The new regime, known as Basel III, seeks to improve the quality of regulatory capital and introduces a new minimum common equity requirement. Basel III also raises the numerical minimum capital requirements and introduces capital conservation and countercyclical buffers to induce banking organizations to hold capital in excess of regulatory minimums. In addition, Basel III establishes for the first time an international leverage standard for internationally active banks. Federal banking regulators are working to implement the Basel III capital reforms in the United States. The Federal Reserve will separately implement consistent capital and liquidity standards for nonbank financial companies designated for enhanced supervision by FSOC.

SIFI to any single unaffiliated company to 25 percent of its total capital stock and surplus.

- **Risk management requirements:** Publicly traded SIFIs must establish a risk committee and be subject to enhanced risk management standards.
- **Stress testing requirements:** The Federal Reserve is required to conduct an annual evaluation of whether SIFIs have sufficient capital to absorb losses that could arise from adverse economic conditions.[69]
- **Debt-to-equity limits:** Certain SIFIs may be required to maintain a debt-to-equity ratio of no more than 15-to-1.
- **Early remediation:** The Federal Reserve is required to establish a regulatory framework for the early remediation of financial weaknesses of SIFIs in order to minimize the probability that such companies will become insolvent and the potential harm of such insolvencies to the financial stability of the United States.

A broad range of financial market regulators, academics, and industry and public interest group experts generally expect the enhanced prudential standards to help increase the resilience of SIFIs and reduce the potential for a SIFI's financial distress to spill over to the financial system and broader economy. Higher capital levels increase a firm's resilience during times of financial stress because more capital is available to absorb unexpected losses. Similarly, increased liquidity (e.g., holding more liquid assets and reducing reliance on short-term funding sources) can reduce the likelihood that a firm will have to respond to temporary strains in credit markets by cutting back on new lending or selling assets at depressed prices. Increased capital and liquidity levels together can limit the potential for large, unexpected losses in the financial system to disrupt the provision of credit and other financial services to households and businesses, which occurred in the most recent financial crisis. Finally, limiting counterparty credit exposures also can help to minimize spillover effects.

[69]Companies subject to enhanced prudential standards also must conduct annual or semi-annual stress tests of their own, depending on their size.

A number of experts viewed the act's enhanced prudential standards for SIFIs as particularly beneficial, because such institutions pose greater risks to the orderly functioning of financial markets than less systemically significant institutions, and subjecting SIFIs to stricter standards can cause them to internalize the costs of the risks they pose to the system. For example, the Federal Reserve intends to issue a proposal that would impose capital surcharges on SIFIs based on a regulatory assessment of the systemic risk they pose, consistent with a framework agreed to by the Basel Committee.[70] In addition, the Dodd-Frank Act's enhanced prudential standards provisions allow federal regulators to impose more stringent risk management standards and oversight of SIFIs' activities, including by conducting stress tests, to help ensure that weaknesses are addressed before they threaten the financial system. Experts noted that these stricter standards, including the surcharges, could serve as a disincentive to financial firms to become larger or otherwise increase the risks they pose to the broader financial system.

Despite generally supporting an increase in the capital requirements, experts questioned the potential effectiveness of certain aspects of the enhanced prudential standards for SIFIs:

- *Impact on "too-big-to-fail" perceptions:* Experts suggested that the market may view SIFIs as too big to fail, paradoxically giving such firms an implicit promise of government support if they run into financial difficulties. As discussed below, perceptions that SIFIs are too big to fail can weaken incentives for creditors to restrain excessive risk-taking by SIFIs and could give such firms a funding advantage over their competitors. However, others noted that the heightened standards were specifically designed to address these issues and view the act as explicitly prohibiting federal government support for SIFIs. For example, the act revises the Federal Reserve Act to prohibit the Federal Reserve from providing support to individual institutions in financial distress and, as discussed below, the act creates a new option for liquidating such firms.

[70] *See* 77 Fed. Reg. 594 (Jan. 5, 2012).The Basel Committee has reached agreement on a framework for capital surcharges on global systemically important banking organizations that would increase their capital requirements by 1 to 2.5 percentage points, depending on their global systemic footprint. In its enhanced prudential standards proposal, the Federal Reserve announced its intention to issue a proposal implementing capital surcharges in the United States along the international timeline and in line with the framework developed by the Basel Committee.

- *Limits of Basel approach to capital standards:* The Federal Reserve will base its enhanced regulatory capital standards, in part, on Basel's approach, which several experts view as having limitations. They recognized that the Basel III standards address some of the limitations that the financial crisis revealed in the regulatory capital framework, but maintain that Basel III continues to place too much reliance on risk-based approaches to determining capital adequacy.[71] During the 2007-2009 crisis, some banks experienced capital shortages, in part because they suffered large losses on assets that were assigned low risk weights under Basel's standards but posed greater risk than their risk weights. The Basel III framework will increase risk weights for certain asset classes—and includes a leverage ratio as a safeguard against inaccurate risk weights—but experts noted that the potential remains for financial institutions to "game" the Basel risk weights by increasing holdings of assets that carry risk-weights that are lower than their actual risks. In addition, some experts maintain that the Basel standards overall may not provide a sufficient buffer to protect firms during times of stress. However, one regulator noted that the leverage ratio, and the higher requirements for common equity and tier 1 capital called for in the Basel III standards, represent a significant tightening of capital regulation (in combination with the imposition of some higher risk weights and better quality of capital).

Implementation of these SIFI provisions is ongoing. In January 2012, the Federal Reserve proposed rules to implement the enhanced prudential standards, but has not yet finalized all of these rules.[72] In addition, the Federal Reserve and other federal prudential regulators are continuing to

[71]Regulators generally require that banks maintain certain ratios of capital as a share of assets to ensure that they have sufficient capital to absorb losses. Under the Basel approaches, banks may weight certain assets based on their risks, and use these risk-weighted assets to calculate their capital adequacy ratios.

[72]On January 5, 2012, the Federal Reserve published proposed rules to strengthen regulation and supervision of large bank holding companies and systemically important nonbank financial companies. The proposal includes a wide range of measures addressing issues such as capital, liquidity, credit exposure, stress testing, risk management, and early remediation requirements. *See* 77 Fed. Reg. 594. The rules concerning stress testing have been finalized. 77 Fed. Reg. 62,378 (Oct. 12, 2012); 77 Fed. Reg. 62,396 (Oct. 12, 2012). The Federal Reserve has also published a proposed rule for large foreign banking organizations and foreign nonbank financial companies supervised by the Federal Reserve. 77 Fed. Reg. 76,628 (Dec. 28, 2012).

work to implement Basel III.[73] As of December 2012 FSOC had not yet designated any nonbank financial companies for Federal Reserve supervision; the Federal Reserve will subsequently be responsible for developing rules for the heightened capital and other prudential standards for these entities.[74]

Orderly Liquidation Authority

Faced with the impending failure of a number of large financial companies during the 2007-2009 financial crisis, federal financial regulators generally had two options: (1) allowing these companies to file for bankruptcy at the risk of exacerbating the crisis (e.g., Lehman Brothers) or (2) providing such companies with emergency funding from the government at the risk of increasing moral hazard (e.g., AIG). As we previously reported, traditional bankruptcy may not be effective or appropriate for financial companies for a variety of reasons.[75] For example, in bankruptcy proceedings for companies that hold derivatives or certain other qualified financial contracts, creditors may terminate such contracts, even though creditors generally may not terminate other contracts because they are subject to automatic stays. Termination of derivative contracts can lead to large losses for the failed firm and other firms through fire sales and other interconnections.[76] For example, the insolvency of Lehman Brothers had a negative effect on financial stability by contributing to a run on money

[73]The Federal Reserve, FDIC, and OCC published in the *Federal Register* in August 2012 joint notices of proposed rulemaking to implement Basel III, the Standardized Approach for risk-based capital, and revisions to the Advanced Approaches for risk-based capital. *See* 77 Fed. Reg. 52,792 (Aug. 30, 2012); 77 Fed. Reg. 52,888 (Aug. 30, 2012); 77 Fed. Reg. 52,978 (Aug. 30, 2012).

[74]In a recent report, we developed indicators to monitor changes in SIFI characteristics that might be suggestive of the Dodd-Frank Act's impact on these firms. See GAO, *The Dodd-Frank Act: Agencies' Efforts to Analyze and Coordinate Their Rules*, GAO-13-101 (Washington, D.C.: Dec. 18, 2012).

[75]GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, GAO-11-707 (Washington, D.C.: July 19, 2011). Certain financial institutions, including insured depository institutions and insurance companies, may not file for protection under the Bankruptcy Code. Broker-dealers may qualify for liquidation, but not reorganization, under either the Bankruptcy Code or the Securities Investor Protection Act of 1970.

[76]Fire sales are the disorderly sale of assets to meet margin requirements or other urgent cash needs. Such a sudden sell-off drives down prices, potentially below their intrinsic value, when the quantities to be sold are large relative to the typical volume of transactions.

market mutual funds and disrupting certain swaps markets.[77] Further, bankruptcy is a domestic legal process that varies by jurisdiction. Thus, the bankruptcy of a financial company with foreign subsidiaries, such as Lehman Brothers, can raise difficult international coordination challenges.

In contrast to the Lehman case, the government provided support to some financial firms, such as AIG, because of concerns that their failures would further disrupt the broader financial system. A number of experts maintain this government assistance increased moral hazard by encouraging market participants to expect similar emergency actions in future crises for large, interconnected financial institutions—in effect, reinforcing perceptions that some firms are too big to fail. The perception of certain firms as too big to fail weakens market discipline by reducing the incentives of shareholders, creditors, and counterparties of these companies to discipline excessive risk taking.[78] For example, creditors and shareholders may not demand that firms they view as too big to fail make adequate disclosures about these risks, which could further undermine market discipline.[79] Perceptions that firms are too big to fail also can produce competitive distortions because companies perceived as 'too big to fail' may be able to fund themselves at a lower cost than their competitors.

The Dodd-Frank Act's Title II provides the federal government with a new option for resolving failing financial companies by creating a process under which FDIC has the authority to liquidate large financial companies, including nonbanks, outside of the bankruptcy process—called orderly liquidation authority (OLA). In general, under this authority, FDIC may be appointed receiver for a financial firm if the Treasury Secretary determines that the firm's failure would have a serious adverse effect on U.S. financial stability. Under OLA, FDIC must maximize the value of the firm's assets, minimize losses, mitigate systemic risk, and minimize moral

[77]Approximately 80 percent of the derivative counterparties to Lehman's primary U.S. derivatives entity terminated their contracts within 5 weeks of Lehman's bankruptcy filing.

[78]Market discipline enables investors and other market participants to constrain the risk taking of financial firms by investing in firms that they view as taking appropriate risks—and withdrawing support for firms engaging in behavior market participants view as excessively risky.

[79]We previously reported that for market discipline to be effective, market participants need access to adequate information about the institutions, and institutions need to have sound risk management systems in place, among other things. See GAO-09-739.

hazard. OLA also establishes additional authorities for FDIC as receiver, such as the ability to set up a bridge financial company and to borrow funds from the Treasury to carry out the liquidation.[80] FDIC can subsequently collect funding for the OLA process from the financial industry after a company has been liquidated.

A range of financial market regulators, academics, and industry and public interest group experts identified a number of ways in which the Dodd-Frank Act's OLA provisions could help mitigate threats to the financial system posed by the failure of SIFIs or other large, complex, interconnected financial companies. First, the OLA framework may be effective in addressing the limitations of the bankruptcy process. For example, experts noted that under OLA, FDIC will be able to control the liquidation process and can temporarily prevent creditors from terminating their qualified financial contracts, the termination of which could prompt fire sales that could be destabilizing.[81] Second, under its rules, FDIC has indicated that it will ensure that creditors and shareholders of a company in OLA will bear the losses of the company. By helping to ensure that creditors and shareholders will bear losses in the event of a failure, OLA could strengthen incentives for creditors and shareholders to monitor these firms' risks. Finally, OLA could help convince market participants that government support will no longer be available for SIFIs, which could increase investors' incentives to demand that SIFIs become more transparent and refrain from taking excessive risks.

[80]GAO, *Bankruptcy: Agencies Continue Rulemaking for Clarifying Specific Provisions of Orderly Liquidation Authority*, GAO-12-735 (Washington, D.C.: July 12, 2012). When FDIC is appointed receiver of the financial company it must liquidate and wind up the affairs of the company, which may involve managing the assets of the company, determining the validity of creditor claims against the company, and paying creditor claims. The act generally requires that all creditors of a financial company with similar priority be treated similarly; however, FDIC has the authority to treat similarly situated creditors differently. In some cases, FDIC may repudiate contracts to which a financial company is a party or may enforce certain contracts that otherwise could have been terminated because of the financial company's insolvency.

[81]FDIC retrospectively examined how it could have used OLA to resolve Lehman Brothers Holdings Inc. and concluded it could have promoted systemic stability and made the shareholders and creditors, not taxpayers, bear the losses. See FDIC, "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," *FDIC Quarterly*, vol. 5, no. 1 (2011). Critics of this report have noted, among other things, that the analysis does not acknowledge the widespread weakness in financial markets that affected many financial institutions during the financial crisis.

Experts also identified a number of potential challenges and limitations of OLA. OLA is new and untested, and its effectiveness in reducing moral hazard will depend on the extent to which the market believes FDIC will use OLA to make creditors bear losses of any SIFI failure. Experts identified a conflict between OLA's goal of eliminating government bailouts on one hand and minimizing systemic risk on the other. For example, if FDIC imposes losses on some creditors of a failed SIFI, these losses could cause other SIFIs to fail.[82] In that regard, some experts observed that governments historically have not allowed potentially systemically important financial firms to fail during a crisis and question whether a different outcome can be expected in the future. Moreover, experts questioned whether FDIC has the capacity to use OLA to handle multiple SIFI failures, which might occur during a crisis. Another concern is that OLA will be applied to globally active financial institutions, and how FDIC and foreign regulators will handle the non-U.S. subsidiaries of a failed SIFI remains unclear.

In addition, SIFIs must formulate and submit to their regulators resolution plans (or "living wills") that detail how they could be resolved in bankruptcy should they encounter financial difficulties.[83] Experts noted that resolution plans may provide regulators with critical information about a firm's organizational structure that could aid the resolution process. The plans also could motivate SIFIs to simplify their structures, and this simplification could help facilitate an orderly liquidation. However, other experts commented that while resolution plans may assist regulators in gaining a better understanding of SIFI structures and activities, the plans may not be useful guides during an actual liquidation—in part because of

[82]A related concern focused on whether FDIC may have the discretion to impose losses on creditors that might be larger than the market would expect or to pull in types of creditors not otherwise subject to losses under the Bankruptcy Code. If FDIC acts counter to the market's expectations, the result could be to undermine market confidence in the OLA process.

[83]Dodd-Frank Act, § 165(d), 124 Stat. 1426–1427, *codified at* 12 U.S.C. § 5365(d). As we previously reported (see GAO-11-707) this provision requires each nonbank financial company supervised by the Federal Reserve and each bank holding company with total consolidated assets of $50 billion or more to submit periodically to the Federal Reserve, FDIC, and FSOC a plan for the firm's rapid and orderly resolution in the event of material financial distress or failure. Such a firm also must submit a report on the nature and extent of credit exposures the company has to significant bank holding companies and significant nonbank financial firms and the same types of exposures such firms have to the reporting firm. The Federal Reserve and FDIC have not yet finalized their joint proposed rule to implement the credit exposure reporting requirements.

the complex structures of the institutions or because the plans may not be helpful during a crisis. Resolution plans also may provide limited benefits in simplifying firm structures, in part because tax, jurisdictional, and other considerations may outweigh the benefits of simplification.

FDIC has finalized key OLA rules and is engaged in a continuing process of clarifying how certain aspects of the OLA process would work.[84] For example, FDIC officials have clarified that the OLA process will focus on the holding company level of the firm, and stated that the creation of the bridge institution will help ensure that solvent subsidiaries may continue to function. In addition, FDIC and the Federal Reserve are in the process of reviewing the first set of resolution plans, which were submitted in July 2012.

Regulation of Swaps

Except for credit default swaps (CDS)—a type of derivative used to hedge or transfer credit risk—other over-the-counter (OTC) swaps and derivative contracts generally were not central to the systemwide problems encountered during the financial crisis, according to FSOC.[85] Nonetheless, FSOC noted that OTC derivatives generally were a factor in the propagation of risks during the recent crisis because of their complexity and opacity, which contributed to excessive risk taking, a lack of clarity about the ultimate distribution of risks, and a loss in market confidence. In contrast to other OTC derivatives, credit default swaps exacerbated the 2007-2009 crisis, particularly because of AIG's large holdings of such swaps, which were not well understood by regulators or other market participants. Furthermore, the concentration of most OTC derivatives trading among a small number of dealers created the risk that the failure of one of these dealers could expose counterparties to sudden losses and destabilize financial markets. While some standardized swaps, such as interest rate swaps, have traditionally been cleared through clearinghouses—which stand between counterparties in

[84]FDIC issued a final rule on July 15, 2011 (which took effect on August 15, 2011) to implement certain provisions to resolve covered financial companies, including (i) recoupment of compensation from senior executives and directors; (ii) the clarification of power to avoid fraudulent or preferential transfers; (iii) the priorities of expenses and unsecured claims; and (iv) the administrative process for initial determination of claims. 76 Fed. Reg. 41,626. In addition, FDIC and the Federal Reserve published a final rule on resolution plans on November 1, 2011. 76 Fed. Reg. 67,323. For more information, see GAO-12-735.

[85]FSOC, *Annual Report*, 2011.

assuming the risk of counterparty default—most CDS and most other swaps have been traded in the OTC market where holders of derivatives contracts bear the risk of counterparty default.[86] In addition, swaps traded in the OTC market have typically featured an exchange of margin collateral to cover current exposures between the two parties, but not "initial" margin to protect a nondefaulting party against the cost of replacing the contract if necessary. As of the end of the second quarter of 2012, the outstanding notional value of derivatives held by insured U.S. commercial banks and savings associations totaled more than $200 trillion.[87]

As noted earlier, Title VII of the Dodd-Frank Act, also known as the Wall Street Transparency and Accountability Act of 2010, establishes a new regulatory framework for swaps to reduce risk, increase transparency, and promote market integrity in swaps markets. Among other things, Title VII generally

- provides for the registration and regulation of swap dealers and major swap participants, including subjecting them to (1) prudential regulatory requirements, such as minimum capital and minimum initial and variation margin requirements and (2) business conduct requirements to address, among other things, interaction with counterparties, disclosure, and supervision;[88]

[86]A derivatives clearinghouse or similar organization enables each party to a derivatives transaction to substitute the credit of the clearinghouse for the credit of the parties, provides for the settlement or netting of obligations from the transaction, or otherwise provides services mutualizing or transferring the credit risk from the transaction. Dealers participate in the derivatives market by quoting prices to, buying derivatives from, and selling derivatives to end users and other dealers.

[87]OCC, *Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter 2012.* According to the report, the four banks with the most derivatives activity held 93.2 percent of all derivatives, while the largest 25 banks accounted for nearly 100 percent of all contracts. OCC noted that changes in notional volumes are generally reasonable reflections of business activity and therefore can provide insight into potential revenue and operational issues. However, the notional amount of derivatives contracts does not provide a useful measure of either market or credit risks.

[88]In general, minimum capital requirements are designed to provide firms with sufficient liquidity to meet unsubordinated obligations to customers and counterparties and sufficient resources to wind down in an orderly manner without the need for a formal proceeding. Minimum margin requirements are generally intended to regulate the amount of credit directed into swaps and related transactions and to help protect swaps entities and their customers from price fluctuations and against losses arising from undue leverage. Minimum margin requirements also can help manage counterparty credit risk.

- imposes mandatory clearing requirements on swaps but exempts certain end users that use swaps to hedge or mitigate commercial risk;[89]
- requires swaps subject to mandatory clearing to be executed on an organized exchange or swap execution facility, which promotes pre-trade transparency (unless no facility offers the swap for trading);[90] and
- requires all swaps to be reported to a registered swap data repository or, if no such repository will accept the swap, to CFTC or SEC, and subjects swaps to post-trade transparency requirements (real-time public reporting of swap data).

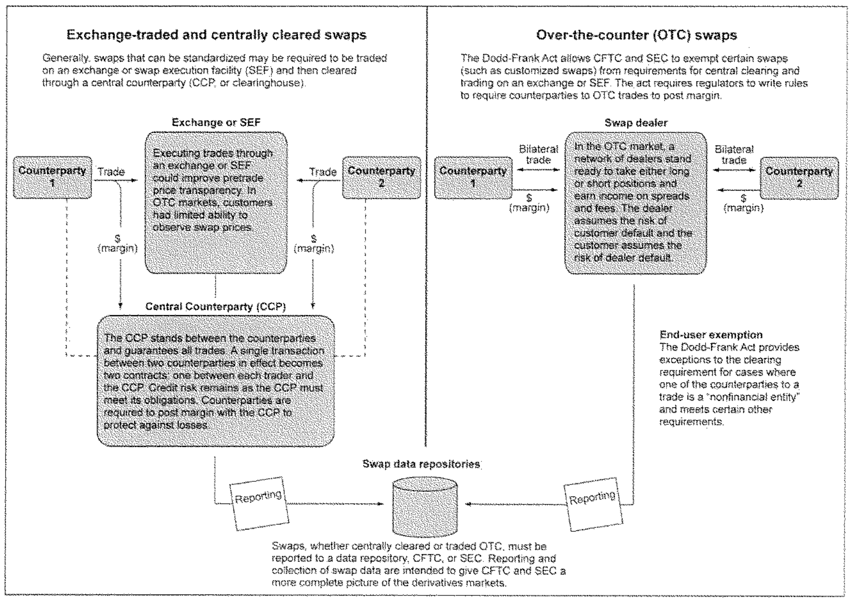
Figure 8 illustrates some of the differences between swaps traded on exchanges and cleared through clearinghouses and swaps traded in the OTC market.[91]

[89]Any entity acting as a clearinghouse, or central counterparty, must register with CFTC, SEC, or both, as appropriate (unless granted an exemption) and is subject to regulatory requirements established by CFTC, SEC, or both, as appropriate.

[90]Organized exchanges and swap execution facilities are subject to comprehensive registration, operational, and self-regulatory requirements.

[91]Clearinghouses use initial and variation margin as a key part of their risk management programs. Initial margin serves as a performance bond against potential future losses. If a clearing member fails to meet its obligations to the clearinghouse (such as failing to pay variation margin when due), resulting in a default, the clearinghouse may use the defaulter's initial margin to cover any loss resulting from the default. Variation margin entails marking open positions to their current market value each day and transferring funds between the clearing members to reflect any change in value since the previous time the positions were marked. This process minimizes the risk that exposures will accumulate over time and thereby reduces the potential impact of a clearing member default and the size of the loss resulting from the default should one occur.

Figure 8: Overview of Clearing, Trading, and Reporting Requirements under Swaps Reforms



Source: GAO analysis of the Dodd-Frank Act.

A broad range of financial market regulators, participants, and observers expect various provisions under Title VII to help promote financial stability, but they also identified potential obstacles or challenges.[92]

[92] In addition to identifying financial stability benefits of Title VII, experts noted that the provisions can provide other benefits to market participants, such as increased market liquidity and lower costs through increased competition and greater transparency.

- **Clearing through clearinghouses:** According to experts, the clearing of swaps through clearinghouses could be beneficial. Clearing can reduce the vulnerability of the financial system to the failure of one or a few of the major swap dealers by transferring credit risk from the swap counterparties to the clearinghouse.[93] By becoming the central counterparty in every trade, a clearinghouse can provide multilateral netting efficiencies to reduce counterparty credit and liquidity risks faced by market participants. Unlike dealers, clearinghouses do not take positions on the trades they clear and may have stronger incentives to develop effective risk management measures and monitor their members' financial condition. In addition, clearinghouses have tools to mitigate counterparty credit risk, for instance, initial and variation margin, as well as the ability to assess their members for additional financial contributions. At the same time, experts have pointed out that clearinghouses concentrate credit risk and thus represent a potential source of systemic risk.[94] For example, a former regulatory official told us that, in her opinion, clearinghouses essentially are too big to fail, given that the Dodd-Frank Act includes provisions mandating centralized clearing of standardized swaps and authorizing the Federal Reserve to provide emergency liquidity to systemically important clearinghouses provided certain conditions are met. Others commented that clearinghouses may be engaged in clearing less standardized or illiquid products, which could pose risk-management challenges for clearinghouses and expose them to greater risks.

- **Margin requirements:** Experts expect the margin requirements for uncleared swaps with swap dealers and major swap participants to help promote financial stability by helping to ensure that market participants have enough collateral to absorb losses. For example, imposing both initial and variation margin requirements on uncleared swaps could help prevent the type of build-up of large, uncollateralized exposures experienced by AIG. Some experts

[93]Counterparty credit risk is the risk to each party in an OTC derivatives contract that the other party will not perform the contractual obligations. Technically, the clearing house members interact with the counterparties.

[94]FSOC has identified certain clearinghouses as systemically important financial market utilities, which are subject to risk management and other enhanced supervisory and prudential requirements under the Dodd-Frank Act and may be afforded access to collateralized emergency liquidity from Federal Reserve Banks in unusual or exigent circumstances.

commented that margin requirements, depending how they are implemented, could have a negative impact on liquidity if there is not a sufficient supply of quality securities that can be posted as collateral to meet margin requirements.

- **Reporting requirements:** Many experts generally expect the swaps reforms that improve transparency to benefit the financial system. For example, the requirement for regulatory reporting of swaps transactions may provide regulators with a better understanding of the current risks in the swaps market and help enhance their oversight of the market. Similarly, public reporting of swap data could benefit market participants by providing them with data on prices and other details about swaps that they can use to better assess their risks. A number of industry representatives noted that the public reporting requirement could lead some market participants to reduce their participation out of fear that others can take advantage of such information. In their view, this could result in a loss of liquidity to the system.

CFTC and SEC have finalized many of the regulations needed to implement Title VII, though several had yet to be finalized as of December 2012. OTC derivatives are globally traded, and many other jurisdictions are in the process of developing new regulatory regimes. However, the United States is one of the first jurisdictions to have enacted legislation in this area. Indeed, the implementation of at least one derivatives-related provision has already been delayed because of the importance of coordinating with international entities. The outcome of the reform process in other jurisdictions will determine the extent to which U.S. firms could be at a competitive advantage or disadvantage. (See app. II for a description of international coordination efforts.)

Mortgage-Related and Other Reforms That Could Enhance Financial Stability

While the previously discussed Dodd-Frank Act provisions were commonly cited as the most important ones for enhancing U.S. financial stability, several financial market regulators, participants, and observers we spoke with identified other provisions that they expect to help enhance financial stability. As with the provisions discussed above, certain key rules implementing the following provisions have not yet been finalized.

- **Mortgage-related reforms:** According to experts, problems in the mortgage market, particularly with subprime mortgages, played a

central role in the recent financial crisis, and the act's mortgage-related reforms may help prevent such problems in the future.[95] Some bank and nonbank mortgage lenders weakened their underwriting standards and made mortgage loans to homebuyers who could not afford them or engaged in abusive lending practices before the crisis. These factors, along with the decline in housing prices, contributed to the increase in mortgage defaults and foreclosures. A number of the act's provisions seek to reform the mortgage market—for example, by authorizing CFPB to supervise nonbank mortgage lenders and by prohibiting certain mortgage lending practices, such as issuing mortgage loans without making a reasonable and good faith effort to determine that the borrower has a reasonable ability to repay.[96] Some industry representatives have expressed concerns that these reforms could prevent certain potential homebuyers from being able to obtain mortgage loans. However, other experts noted that before the crisis some loans had rates that did not fully reflect their risks, which contributed to an excess of credit, and the act's reforms may help ensure that loans are accurately priced to reflect risks. Many of the Dodd-Frank Act's mortgage reforms have not yet been implemented through rulemaking.

- **Risk retention for asset securitizations:** According to experts, the securitization of residential mortgages into mortgage-backed securities that subsequently were part of other securitizations also played a central role in the crisis, and the act contains provisions to reform the market.[97] Experts also noted that institutions that created mortgage-backed securities in the lead-up to the crisis engaged in a number of practices that undermined the quality of their securities,

[95]Subprime mortgages generally are made to borrowers with blemished credit and feature higher interest rates and fees than prime loans. We have previously reported that the subprime market experienced substantially steeper increases in default and foreclosure start rates than the prime and government insured markets, accounting for two thirds or more of the overall increase in the number of loans between the second quarter of 2005 and the second quarter of 2007. See GAO, *Information on Recent Default and Foreclosure Trends for Home Mortgage and Associated Economic and Market Developments,* GAO-08-78R (Washington, D.C.: Oct. 16, 2007).

[96]According to the Dodd-Frank Act, a lender is presumed to have satisfied this requirement and receives some protection from liability when it originates a "qualified mortgage" (QM) that meets nine specific criteria, initially set forth in the act, but authorizes CFPB to change these criteria.

[97]A securitization is a financial transaction in which assets, such as mortgage loans, are pooled and securities representing interests in the pool are issued.

including not adequately monitoring the quality of the mortgages underlying their securities, because they did not bear the risk of significant losses if those mortgages defaulted.[98] The act contains provisions that require securitizers of asset-backed securities to retain some "skin in the game" in the form of a certain percentage of the credit risk in asset-backed securities they create.[99] However, experts have different views on the extent to which the level of risk retention for securitizations was central to the problems encountered during the recent crisis, and a few do not view these provisions as potentially beneficial for financial stability. Regulators proposed implementing rules for the provision in 2011 but had yet to finalize the rules as of December 2012.

- **The Volcker rule:** The role that proprietary trading—trading activities conducted by banking entities for their own account as opposed to those of their clients—played in the recent crisis is a matter of debate.[100] However, a number of experts maintain that the ability of banking entities to use federally insured deposits to seek profits for their own account provides incentives for them to take on excessive risks. In particular, some have noted that commercial banks that benefit from the federal financial safety net enjoy access to subsidized capital and thus do not bear the full risks of their proprietary trading activities. To address these concerns, section 619 of the Dodd-Frank Act, referred to as the Volcker rule, generally prohibits a banking entity from engaging in proprietary trading or acquiring or retaining

[98]To securitize mortgage loans, mortgage lenders or originators can either securitize the loans themselves or sell their loans to third parties (some of which are affiliated third parties)—either directly to securitizing institutions or loan aggregators that serve as intermediaries between originators and securitizers—generating funds that could be used to originate more loans. Securitizing institutions include investment banks, retail banks, mortgage companies, and real estate investment trusts.

[99]Dodd-Frank Act, § 941, 124 Stat. at 1890–1896, *codified at* 15 U.S.C. § 78o–11. Specifically, the Dodd-Frank Act requires mortgage securitizers (and certain originating lenders) to retain a financial exposure of no less than 5 percent of the credit risk of any securitized residential mortgage that does not meet a separate set of criteria (to be defined by six federal regulators, excluding CFPB). Securitized mortgages that meet these criteria are exempt from this risk retention requirement, referred to as "qualified residential mortgage" (QRM). The QRM risk retention requirement can be more restrictive than the QM criteria but not less restrictive. 15 U.S.C. § 1639c(b)(2)(A), (3)(B)(i), (c)(1)(B).

[100]See GAO, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented*, GAO-11-529, (Washington, D.C.: July 13, 2011).

more than a certain maximum percentage of any equity, partnership, or other ownership interest in, or sponsoring, a hedge fund or a private equity fund, among other restrictions involving transactions between covered banking entities and sponsored hedge funds and private equity funds.[101] A number of experts view these restrictions as enhancing financial stability by discouraging excessive risk-taking by these institutions. Others, however, have noted that the Volcker rule, by prohibiting certain proprietary activities of these institutions, could have adverse effects on liquidity and, in turn, the unintended effect of undermining financial stability. In 2011, regulators proposed rules to implement the Volcker rule but had not yet finalized them as of December 2012.

Other Dodd-Frank Provisions May Lead to Additional Consumer and Investor Benefits

Financial market regulators, participants, and observers whom we interviewed also identified provisions that may result in benefits beyond increased financial stability. For example, the act may enhance consumer and investor protections and improve economic efficiency. As with the provisions previously noted, the realization of such benefits will depend, in part, on how regulators implement the provisions. Benefits beyond financial stability that experts highlighted include the following:

- **Enhanced consumer protections:** The Dodd-Frank Act's Title X consolidates rulemaking and other authorities over consumer financial products and services under CFPB. The new agency assumes authority to implement consumer protection laws, such as the Truth in Lending Act and Home Ownership and Equity Protection Act of 1994. CFPB could assist consumers by improving their understanding of financial products and services.[102] For example, experts noted that consumers could benefit from CFPB's efforts, which include providing information on consumer financial products and simplifying

[101]Dodd-Frank Act § 619, 124 Stat. at 1620-1631 *codified at* 12 U.S.C. § 1851. Section 619 of the act requires the federal banking agencies, SEC, and CFTC to promulgate rules implementing the prohibition. 12 U.S.C. § 1851(b). The Volcker Rule also generally prohibits a banking entity from engaging in any permitted activity that, among other things, would involve or result in a material conflict of interest between the banking entity and its customers or that would result in a material exposure to a high-risk asset or trading strategy. 12 U.S.C. § 1851(d)(2)(A)(i).

[102]Board of Governors of the Federal Reserve System and Department of the Treasury Offices of Inspector General, *Review of CFPB Implementation Planning Activities* (Washington, D.C.: July 15, 2011).

disclosures for mortgages, credit cards, and other consumer financial products.

- **Enhanced investor protections:** Certain provisions in the act could provide shareholders with greater influence over, and insight into, the activities of publicly traded companies. For example, the act contains provisions that require shareholder advisory votes on executive compensation, disclosure of the ratio between the chief executive officer's annual total compensation and median annual total compensation for all other employees, and clawback policies for erroneously awarded incentive-based compensation.[103]

- **Improving resource allocation in the economy:** Some experts noted that mortgages and related credit instruments were not accurately priced before the crisis to reflect their risks. As a result, the economy experienced a credit bubble that facilitated a misallocation of resources to the housing sector. For example, one expert noted that residential housing construction during the 2000s was excessive and inefficient. To the extent that the act contributes to a more accurate pricing of credit, the economy could benefit from a more efficient allocation of resources across the broader economy.

Quantifying Potential Benefits Is Difficult, but Some Approaches May Provide Useful Insights

The Dodd-Frank Act's potential benefit of reducing the probability or severity of a future financial crisis cannot be readily observed and this potential benefit is difficult to quantify. Any analyses must be based on assumptions about, or models of, the economy. Consequently, the results of such analyses are subject to substantial uncertainty. Nonetheless, as we noted previously in this report, a working group of the Basel Committee on Banking Supervision summarized several studies that analyze the costs of financial crises, and that used different macroeconomic models of the economy to estimate the impact of more

[103]Dodd-Frank Act, §§ 951, 953, 954, 124 Stat. at 1899–1900, 1903–04, *codified at* 15 U.S.C. §§ 78n–1, 78j–4, 78*l* note. Clawbacks of erroneously awarded incentive-based compensation are recoveries by the company of amounts paid to an employee based on materially inaccurate financial statements. This is money that the executive would not have received if the accounting were done properly and to which the executive was not entitled.

stringent capital and liquidity standards on the annual likelihood of a financial crisis, and the benefits of avoiding associated output losses.[104]

The Basel Committee report suggests that increases in capital and liquidity ratios are associated with a reduction in the probability that a country will experience a financial crisis. Higher capital and liquidity requirements may generate social benefits by reducing the frequency and severity of banking crises and the consequent loss of economic output. The Basel Committee working group found that although there is considerable uncertainty about the exact magnitude of the effect, the evidence suggests that higher capital and liquidity requirements can reduce the probability of banking crises. For example, the models suggest, on average, that if the banking system's capital ratio—as measured by the ratio of tangible common equity to risk-weighted assets—is 7 percent, then a 1 percentage point increase in the capital ratio is associated with a 1.6 percentage point reduction in the probability of a financial crisis—from 4.6 percent to 3.0 percent per year. The working group also found that if the capital ratio was 7 percent, then a 12.5 percent increase in the ratio of liquid assets to total assets in the banking system is associated with a 0.8 percentage point reduction in the probability of a crisis per year, on average. In addition, the incremental benefits of higher capital requirements are greater when bank capital ratios are increased from lower levels and they decline as standards become progressively more stringent. For example, the models suggest, on average, that the reduction in the likelihood of a crisis is three times larger when the capital ratio is increased from 7 percent to 8 percent than it is when the capital ratio is increased from 10 percent to 11 percent. The further away banks are from insolvency, the lower their marginal benefit is from additional protection.

Estimates of the reduced probability of a financial crisis are subject to a number of limitations. For example, researchers note that the reduction in the probability of a crisis depends on the baseline assumptions about the average probability of a crisis before the policy changes—in this case, before the increase in capital requirements. In addition, overall economic conditions, or factors outside of the financial system, also may affect the probability of a financial crisis.

[104]Basel Committee on Banking Supervision, "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements," Bank for International Settlements (Basel, Switzerland: Aug. 2010).

The Basel Committee working group also summarized the studies' estimates of the potential benefits from higher capital and liquidity requirements in terms of economic output gains that could result from a lower probability of a crisis. The studies used estimates of the costs of a crisis to estimate that a 1 percent decrease in the annual probability of a crisis could have a benefit of 0.2 percent to 1.6 percent per year of increased economic output, depending on the extent to which the crisis losses are temporary or permanent. If, for example, annual GDP were $15 trillion (around the size of U.S. GDP) these estimates suggest that the economic benefit in terms of increased GDP could range from approximately $29 billion to about $238 billion per year. These estimates also are subject to limitations, however. As we previously discussed in this report, estimates of financial crisis losses have varied widely depending on the assumptions made. In addition, these models did not take into account variations in responses to higher capital and liquidity requirements among institutions and regulatory environments.

Given the difficulty of measuring the extent to which the Dodd-Frank Act may reduce the probability of a future crisis, a few academics have proposed a more conceptual approach for comparing the act's potential benefits and costs.[105] According to these experts, the benefits of the act can be framed by determining the percent by which the cost of a financial crisis needs to be reduced to be equal to the act's costs. If the cost of a future crisis is expected to be in the trillions of dollars, then the act likely would need to reduce the probability of a future financial crisis by only a small percent for its expected benefit to equal the act's expected cost. Although an academic told us this thought exercise helped put the benefits and costs of the Dodd-Frank Act into perspective, it provides no insight into whether the act reduces the probability of a future crisis by even a small percent.

[105]See, for example, Steven Schwarcz, "Systemic Risk," *Georgetown Law Journal*, vol. 97: 193-249 (2008).

Significance of the Act's Costs Is Not Fully Known

The Dodd-Frank Act requires federal agencies and the financial services industry to expend resources to implement or comply with its requirements, and some of its reforms are expected to impose costs on the economy. First, federal agencies are devoting resources to fulfill rule-making and other new regulatory responsibilities created by the act. A large portion of these agency resources are funded by fees paid by industry participants or other revenue sources outside of congressional appropriations, limiting the impact of these activities on the federal budget deficit. Second, the act contains a broad range of reforms that generally are imposing or will impose additional regulations and costs on a correspondingly broad range of financial institutions, including banks, broker-dealers, futures commission merchants, investment advisers, and nonbank financial companies. Given the act's focus on enhancing financial stability, large, complex financial institutions will likely bear the greatest costs, but smaller financial institutions and other financial market participants also will incur costs.[106] Third, by imposing costs on the financial services industry, the act also may impose costs on the broader economy and reduce output. For example, financial institutions may charge their customers more for credit or other financial services. While the act's costs can be viewed as the price to be paid to achieve a more resilient financial system and other benefits, some industry representatives question whether the costs, individually or cumulatively, are excessive. Furthermore, observers have also expressed concerns about potential unintended consequences of the act, such as reducing the competiveness of U.S. financial institutions in the global financial marketplace.

Resources Devoted to the Dodd-Frank Act's Implementation Vary Widely across Federal Agencies

The amount of funding that 10 federal financial entities have reported as associated with their implementation of the Dodd-Frank Act varied significantly from 2010 through 2013, and the amounts have been increasing for some of these entities. Funding resources associated with the Dodd-Frank Act's implementation from 2010 through 2012 ranged from a low of $4.3 million for FHFA to a high of $432.3 million for CFPB (see table 2). In addition, funding associated with the act's implementation increased from 2011 through 2012 for all but one of the agencies, FHFA, and more than doubled for four entities: OFR, FSOC,

[106]See, for example, GAO, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881 (Washington, D.C.: Sept. 13, 2012).

CFPB, and OCC. Three of these four entities—OFR, FSOC, and CFPB—were created through the Dodd-Frank Act and thus are in the process of establishing management structures and mechanisms to carry out their missions. Likewise, according to CFPB and OFR, while some of their funding was used for recurring staffing costs, other funding was used for start-up costs, such as systems development, contractor support, and data purchases. According to FSOC and OFR, the increase in funding is directly proportional to the growth in their staffing and reflects an increase in the size and scope of their organizations. Some new funding resources reported by agencies may represent transfers between entities rather than new funding resources. For example, the large increase in Dodd-Frank-related funding for OCC between 2011 and 2012 reflects OCC's integration of OTS responsibilities and staff, according to OCC officials. In addition, new funding resources for CFPB include some funding resources transferred from the Federal Reserve. In such cases, these new funding resources do not represent an incremental cost of the act's implementation.

Table 3: Summary of 10 Federal Entities' Reported Funding Resources Associated with Implementation of the Dodd-Frank Act, 2010 through 2013

(dollars in millions)

Agency/Entity	2010	2011	2012	2010-2012 Total	2013 Projections
FSOC[a]	$0.0	$2.9	$6.0	$8.9	$8.7
OFRa	0.0	11.3	39.5	50.8	78.1
CFPB[a]	9.2	123.3	299.8	432.3	447.7
Federal Reserve	7.3	62.7	93.1	163.1	Not available
CFTC	0.0	15.4	21.9	37.3	80.0
SEC	0.0	23.5	39.5	63.0	129.0
FDIC	2.3	19.9	38.1	60.3	Not available
FHFA	0.0	2.2	2.1	4.3	2.1
OCC	0.0	34.9	235.0	269.9	Not available
Treasury	0.0	5.6	9.2	14.8	9.4

Source: GAO presentation of data from individual entities.

Note: For 2010, 2011, and 2012, FSOC, OFR, CFPB, and Treasury provided estimates of actual resources expended on Dodd-Frank-related activities, and the other agencies provided estimates of the total resources made available or requested for Dodd-Frank-related activities. Federal Reserve and FDIC data are reported on a calendar year basis, but the other agency data are reported on a fiscal year basis. At the time of this review, the Federal Reserve, FDIC and OCC did not provide projections for 2013.

[a]New entity.

To meet their Dodd-Frank-related responsibilities, federal entities reported that they have hired new staff, redirected staff from other areas, or used staff transferred from other entities. The number of full-time equivalents (FTE) reported by the 10 federal entities as associated with their implementation of the act also varied significantly from 2010 through 2013, and the amounts have been increasing for some entities (see table 3). The entities' estimates of new FTEs related to implementing the Dodd-Frank provisions for 2010 through 2012 ranged from a low of 18 for FHFA to a high of 964 for the Federal Reserve. Some new FTEs reported by agencies represent transfers of staff between agencies rather than new hires. New FTEs for OCC in 2011 include staff transferred from OTS. In addition, new FTEs for CFPB include staff transferred from the agencies whose consumer protection responsibilities were transferred to CFPB. In such cases where new FTEs for an entity have resulted from a transfer of existing regulatory responsibilities between entities, these new FTEs do not represent an incremental cost of the act's implementation.

Table 4: Summary of 10 Federal Entities' Reported New and Redirected Full-Time Equivalents Associated with Implementation of the Dodd-Frank Act, 2010 through 2013

Agency/Entity	2010	2011	2012	2010-2012 Total	2013 Projections
FSOC	0	17	7	24	0
OFR	0	13	47	60	167
CFPB	0	178	653	831	528
Federal Reserve	69	367	528	964	Not available
CFTC	0	121	126	247	268
SEC	0	14	51	65	227
FDIC	0	55	91	146	Not available
FHFA	0	16	2	18	9
OCC	0	133	0	133	0
Treasury	0	33	10	43	3

Source: GAO presentation of data from individual entities.

Note: Federal Reserve and FDIC data are reported on a calendar year basis, and the other agency data are reported on a fiscal-year basis. At the time of this review, the Federal Reserve and FDIC did not provide projections for 2013. OCC reported that 131 FTEs for fiscal year 2011 were transferred from OTS, which the Dodd-Frank Act dissolved as of July 21, 2011. Because these FTEs were already on board at the beginning of fiscal year 2012, they are not considered new Dodd-Frank-related FTEs in fiscal year 2012. OCC also noted that the ongoing aspects of the Dodd-Frank Act, such as rulemakings and participating in FSOC-related activities, have been integrated into the agency's ongoing programs and activities and thus are not shown as separate initiatives related to the act's implementation.

A large portion of the federal entities' resources devoted to the act's implementation are funded by fees paid by regulated institutions or other sources outside the congressional appropriations process, limiting the impact of these activities on the federal budget deficit. Seven of the entities (CFPB, FSOC, OFR, FDIC, FHFA, OCC, and the Federal Reserve) are funded in full through assessments, fees, or other revenue sources and, thus, have not received any congressional appropriations. Moreover, FSOC and OFR are funded by assessments on large bank holding companies and nonbank financial companies designated by FSOC for supervision by the Federal Reserve.[107] SEC receives appropriations, but SEC collects transaction fees and assessments that are designed to recover the costs to the federal government of its annual appropriation. CFPB receives a mandatory transfer of funding from the Federal Reserve, subject to certain limits, but may request discretionary appropriations. Treasury and CFTC are funded through congressional appropriations.[108] Although entities' funding resources and staff have increased due to implementation of the act, these increases are not expected to have a significant impact on the federal deficit. In 2011, CBO estimated that the Dodd-Frank Act would reduce federal deficits by $3.2 billion over the period from 2010 to 2020.[109] CBO projected that the act would increase revenues by $13.4 billion and increase direct spending by $10.2 billion over this period. While CBO's analysis did not consider the potential impacts of the act's reforms on economic growth, its estimates suggest that the size of the act's direct impacts on federal spending is small relative to total federal net outlays of $3.6 trillion in fiscal year 2011. While fees and assessments paid by financial institutions to the federal

[107]FSOC and OFR have not received appropriated funds. During the 2-year period following the enactment of the Dodd-Frank Act, the Federal Reserve provided OFR funds to cover the expenses of the office. Now, OFR is funded through assessments levied on bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by FSOC for supervision by the Federal Reserve. Until FSOC designates nonbank financial companies, assessments will be levied only against large bank holding companies. The collected assessments are deposited into the Financial Research Fund, which was established within Treasury to fund the expenses of OFR. FSOC's expenses are considered expenses of OFR. 12 U.S.C. §§ 5328, 5345.

[108]Some of Treasury's expenses are funded through statutory provisions that authorize Treasury to spend certain of its receipts.

[109]See D. Elmendorf, CBO, "Review of CBO's Cost Estimate for the Dodd-Frank Wall Street Reform and Consumer Protection Act" (testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, Washington, D.C., Mar. 30, 2011).

entities help to limit the act's direct impacts on the federal budget deficit, they represent a cost to these institutions and could have indirect impacts on the economy, as discussed later in this report.

In collecting and analyzing this information, we found challenges and limitations that affected our efforts to aggregate the data. For example, agencies told us that their reported funding and FTE resources for 2013 reflect their best estimates of the level of resources required to implement existing and new responsibilities but stated that these estimates were uncertain. As shown in tables 3 and 4, a few agencies did not provide projections for 2013 resources related to the act's implementation. In addition, not all of the federal entities are on a federal fiscal year, so the reported budgetary activities for some entities cover different time frames. Moreover, the entities may have used different approaches to estimate the funding and FTE resources, potentially making the figures harder to compare across entities.

The Act Imposes Costs on the Financial Services Industry but Limited Data Exist on the Magnitude of the Costs

The Dodd-Frank Act's provisions and regulations generally impose or are expected to impose costs on banks and other financial institutions. According to some academics and others, certain types of costs imposed by the act on financial institutions serve to make such institutions internalize costs that they impose on others through their risk-taking and thereby reduce the risk that they pose to the financial system. The extent to which the act imposes costs on financial institutions may vary among not only different types of financial firms (e.g., banks versus nonbank financial companies) but also among the same types of firms (e.g., large banks versus small banks). In discussions with regulators, industry representatives, and other experts, we identified two main categories of financial impacts on financial institutions: (1) increased regulatory compliance and other costs and (2) reduced revenue associated with new restrictions on certain activities.[110] However, as commonly noted by financial firms in their annual reports, the Dodd-Frank Act's full impact on their businesses, operations, and earnings remains uncertain, in part

[110]Compliance costs generally are the costs that firms incur to undertake an activity that they otherwise would not have undertaken in the absence of regulation. Such costs include the costs for regulated firms to hire and train staff, devote staff and management time to compliance activities, hire outside legal or other expertise, and make new investments in information technology or other systems. Compliance costs can include start-up, or one-time, costs (e.g., upgrading computer systems) and recurring costs (e.g., periodic reporting requirements).

because of the rulemakings that still need to be completed. For example, in its 2012 annual report, one large bank holding company noted that it could not quantify the possible effects of the significant changes that were under way on its business and operations, given the status of the regulatory developments. Furthermore, even when the reforms have been fully implemented, it may not be possible to determine precisely the extent to which observed costs can be attributed to the act versus other factors, such as changes in the economy.

Regulatory Compliance and Other Costs

No comprehensive data are readily available on the costs that the financial services industry is incurring to comply with the Dodd-Frank Act. Representatives from financial institutions and industry associations told us that firms generally do not track their incremental costs for complying with the act. Moreover, they said that the piecemeal way that the act is being implemented makes it difficult to measure their regulatory costs. Likewise, none of the industry associations we met with are tracking the incremental costs that their members are incurring to comply with the act. Regulators and others have collected some data on certain compliance costs. Specifically, federal agencies typically estimate the cost of complying with any recordkeeping and reporting requirements of their rules under the Paperwork Reduction Act, but these estimates do not capture other types of compliance costs, which can be more substantial.[111] For example, an SEC rule on asset-backed securities requires issuers of such securities to conduct, or hire a third party to conduct, a review of the assets underlying the securities; this cost is not a paperwork-related cost and thus not included in the compliance costs captured under the Paperwork Reduction Act.[112] In May 2012, the Treasury Secretary asked the Federal Reserve's Federal Advisory Council, a group of bank executives, to prepare a study to provide regulators with more specific examples of the regulatory burdens imposed by the act's reforms.

A number of the Dodd-Frank Act provisions target large financial firms and are expected to increase their compliance or other costs more

[111]See GAO, *Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination*, GAO-12-151 (Washington, D.C.: Nov. 10, 2011). OCC reviews potential costs and benefits of each proposed rule in accordance with requirements of the Unfunded Mandates Reform Act, the Regulatory Flexibility Act, and the Congressional Review Act.

[112]76 Fed. Reg. 4231 (Oct. 13, 2010).

significantly than for other financial firms. In particular, several provisions specifically apply to SIFIs, which include bank holding companies with $50 billion or more in total consolidated assets (which we refer to as "bank SIFIs") and nonbank financial companies designated by FSOC for supervision by the Federal Reserve. Examples of provisions targeting large financial institutions include the following:

- **Enhanced prudential standards:** Higher capital and liquidity requirements can increase funding costs for banks.[113] Studies by the Basel Committee on Banking Supervision, IMF, and Organization for Economic Cooperation and Development estimated that increased capital and liquidity requirements would have modest impacts on funding costs for financial institutions. In contrast, a study by the International Institute of Finance, a global association of financial institutions, found much larger negative impacts. Differences in these studies' estimates result from differences in certain assumptions. For example, the size of the estimated impact on funding costs depends on assumptions about how much of the increase in banks' capital levels is due to regulatory reforms rather than other factors. Some researchers have noted that attributing all of the increase in banks' capital levels to regulatory reforms may overstate the cost impacts of these reforms, because banks likely increased their capital levels, to some extent, in response to market forces after the crisis.

- **Resolution plans:** Regulators and industry officials stated that bank SIFIs have devoted significant staffing resources to developing the required resolution plans and that some plans submitted in July 2012

[113]Higher capital requirements can require banks to increase the portion of their funding that comes from equity capital rather than debt. Heightened liquidity standards can require banks to rely more on longer-term rather than shorter-term debt financing. The results of academic, industry, and other research on the impact of such heightened prudential standards on financial institutions and their customers have varied widely. It generally is more expensive for banks to fund themselves through equity capital (such as by selling stock to investors) than through debt. This is because equity holders are residual claimants and assume more risk than debt holders. In theory, increasing the required proportion of equity funding relative to debt funding should not affect a firm's overall cost of funding as it reduces the risk that the firm will fail, thereby reducing the returns demanded by both equity and debt holders. However, certain government policies make equity financing (such as through issuing stock to investors) more expensive for financial institutions than debt financing. For example, interest on debt is tax deductible, while dividends on equity securities are not. In addition, bank deposits benefit from federal guarantees and the cost of these liabilities does not fall as capital levels and the perceived safety of the firm increase.

were thousands of pages in length.[114] Regulators estimated that each bank SIFI required to complete a full resolution plan (20 banks) will spend, on average, 9,200 hours to complete the first plan and 2,561 hours to update the plan annually.[115]

- **Stress tests:** In accordance with the act, the Federal Reserve, OCC, and FDIC have issued rules for stress testing requirements for certain bank holding companies, banks, thrift institutions, state member banks, savings and loan companies, and nonbank financial companies FSOC designates for supervision by the Federal Reserve.[116] Bank holding companies with $50 billion or more in assets and nonbank financial companies designated by FSOC will be required to conduct company-run stress tests semi-annually, and the Federal Reserve will be required to conduct stress tests on these companies annually. Financial companies with more than $10 billion but less than $50 billion in assets will be required to conduct company-run stress tests annually as directed by their primary federal banking supervisor. According to industry representatives, stress testing requires newly covered firms to incur significant compliance costs associated with building information systems, contracting with outside vendors, recruiting experienced personnel, and developing stress testing models that are unique to their organization.
- **Regulatory assessments:** The Dodd-Frank Act also increases operating costs for SIFIs and certain large banks through new or higher regulatory assessments. First, under the act, large bank holding companies and nonbank financial companies designated by FSOC for supervision by the Federal Reserve must fund the Financial Research Fund, which funds the operating costs of FSOC and OFR, and certain expenses for the implementation of the orderly liquidation activities of FDIC, through a periodic assessment.[117] The President's

[114]Dodd-Frank Act, § 165(d), 124 Stat. at 1426–1427, *codified at* 12 U.S.C. § 5365(d); 76 Fed. Reg. 67,323 (Nov. 1, 2011).

[115]As discussed earlier, SIFIs must develop annual resolution plans that describe how their institution's failure would proceed through bankruptcy. The rule allows less complex SIFIs to file a tailored resolution plan with reduced information requirements.

[116]77 Fed. Reg. 62,378 (Oct. 12, 2012); 77 Fed. Reg. 62,396 (Oct. 12, 2012); 77 Fed. Reg. 62,417 (Oct. 15, 2012); and 77 Fed. Reg. 61,238 (Oct. 9, 2012).

[117]Dodd-Frank Act, § 155(d), 124 Stat. at 1419, *codified at* 12 U.S.C. § 5345(d); 77 Fed. Reg. 29,884 (May 21, 2012).

fiscal year 2013 budget included estimates of about $158 million for the Financial Research Fund for fiscal year 2013.[118] Second, pursuant to the act, FDIC issued a final rule changing the assessment base for the deposit insurance fund and the method for calculating the deposit insurance assessment rate.[119] According to FDIC, the change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than smaller institutions, but without affecting the overall amount of assessment revenue collected. According to FDIC data, following implementation of the new assessment base, from the first to the second quarter of 2011, total assessments for banks with $10 billion or more in assets increased by $413 million.[120]

In addition to increasing compliance costs for SIFIs and other large financial institutions, Title VII of the Dodd-Frank Act establishes a new regulatory framework for swaps, which is expected to impose substantial compliance and other costs on swap dealers, which generally include large banks, and other swap market participants.

- **Business conduct standards:** Swap dealers and major swap participants will face increased costs to comply with new business conduct standards under the act. These requirements address, among other things, interaction with counterparties, disclosure, reporting, recordkeeping, documentation, conflicts of interest, and avoidance of fraud and other abusive practices. Under CFTC's final rules, swap dealers and major swap participants will need to adopt or amend written policies and procedures, obtain needed representations from counterparties, and determine whether existing counterparty relationship documents need to be otherwise changed or supplemented.

[118] As noted earlier, the Federal Reserve funded the Financial Research Fund through July 20, 2012.

[119] Dodd-Frank Act, §§ 332, 334, 124 Stat. at 1539, *codified at* 12 U.S.C. § 1817; 76 Fed. Reg. 10,672 (Feb. 25, 2011). The deposit insurance fund insures deposits at banks. Deposit insurance fund assessments are insurance assessments collected from its member depository institutions.

[120] After the rule became effective on April 1, 2011, deposit insurance fund assessments for community banks (those with less than $10 billion in assets) decreased in aggregate by $342 million.

- **Clearing, exchange trading, and data reporting:** Changes to the market infrastructure for swaps—such as clearing and exchange-trading requirements—and real-time reporting requirements for designated major swap dealers or major swap participants will require firms to purchase or upgrade information systems. Industry representatives and regulators said that while some compliance costs of the derivatives reforms could be recurring, a large part of these costs will come from one-time upfront investments to update processes and technology. For example, according to industry groups and agency officials, the real-time reporting and swap execution facility technology upgrades for reporting are among the largest technology investment compliance cost areas for derivatives reforms, and costs to develop new reporting technology for firms may vary depending on the compatibility of the new reporting system with the prior system used. In its final rule on real-time reporting of swap data, CFTC estimated that the annual information collection burden on swap dealers and major swap participants would be approximately 260,000 hours.[121]

- **Margin rules:** Swap dealers and end users will incur costs to post the additional collateral required under the new margin rules, including costs to borrow assets to pledge as collateral.[122] For newly raised funds, the net cost would be the difference between the interest rate paid on the borrowed funds and the interest rate earned on the securities purchased to use as collateral. Estimating the incremental costs is difficult, in part because the incremental cost must take into account the extent to which swap dealers in the past, even if they did not require margin explicitly, may have charged end users more to price in a buffer to absorb losses.

Although the Dodd-Frank Act reforms are directed primarily at large, complex U.S. financial institutions, many of the act's provisions are

[121] 77 Fed. Reg. 1182 (Jan. 9, 2012).

[122] One study estimates that over half a trillion dollars of net new collateral could be required as a result of moving swaps to clearinghouses. See, for example, M. Singh, *Collateral, Netting and Systemic Risk in the OTC Derivatives Market*, IMF Working Paper, 10/99 (Washington, D.C.: 2010). Swap market participants will face costs associated with funding this additional collateral. Among other options, swap dealers could sell longer-term securities to replace them with lower-yielding government securities that are eligible as collateral. For non-dealers, one option is to borrow funds in order to buy securities to use as collateral.

expected to impose costs on other financial institutions as well. For example, we recently reported that the act's reforms covering residential mortgages, securitizations, executive compensation, and other areas may impose additional requirements and, thus, costs on a broad range of financial institutions, but the magnitude of these costs will depend on, among other things, how the provisions are implemented.[123]

Limitations or Restrictions on Business Activities

In addition to imposing compliance and other costs on financial institutions, the Dodd-Frank Act's provisions may limit or restrict financial institutions' business activities and reduce their revenue or revenue opportunities.[124] Examples of such provisions include the following.

- **Volcker rule:** By generally prohibiting banks from engaging in proprietary trading and limiting their ability to sponsor or invest in hedge and private equity funds, the restrictions could eliminate past sources of trading and fee income for some banks.[125] In addition, according to industry representatives, some banks currently holding private funds face the risk of incurring losses on the investments, if they are required to liquidate such investments at a substantial discount within an allotted period.
- **Swaps reform:** The provisions of the Dodd-Frank Act requiring central clearing and exchange trading of certain swaps could reduce the volume of dealers' higher-profit margin swaps and thereby reduce their revenue. In addition, the margin requirements could reduce the ability of U.S. dealers to compete internationally, according to industry representatives.
- **Single counterparty credit limit:** Section 165(e) of the act directs the Federal Reserve to establish single-counterparty credit limits for SIFIs to limit the risks that the failure of any individual company could

[123]See GAO-12-881.

[124]Some reforms may reduce revenue or profits for certain financial institutions but benefit other market participants and, thus, may not necessarily result in a net cost to the broader economy. As discussed later in this report, reforms that effect transfers between groups can give rise to economic costs if there are efficiency losses associated with these transfers.

[125]As we previously reported, while bank holding companies earned profits from their proprietary trading operations in most years, in some years they suffered significant losses. See GAO-11-529.

pose to a SIFI. According to industry representatives, the Federal Reserve's proposed rule to implement credit limits would, among other things, require some SIFIs to reduce their derivatives and securities lending activities.

- **Debit card interchange fees:** Under section 1075 of the act (known as the Durbin amendment) the Federal Reserve issued a final rule that places a cap on debit card interchange fees charged by debit card issuers with at least $10 billion of assets.[126] In their SEC filings, several large debit card issuers have estimated lost revenues from the Durbin amendment to be in the hundreds of millions of dollars annually. Similarly, we recently reported that large banks that issue debit cards initially have experienced a decline in their debit interchange fees as a result of the rule but that small banks generally have not.[127] The reduction in debit interchange fees following the adoption of the rule likely has resulted or will result in savings for merchants. However, debit card issuers, payment card networks, and merchants are continuing to react to the rule; thus, the rule's impact has not yet been fully realized.

While the Dodd-Frank Act Could Impose Costs on the Economy, Quantifying Such Costs Is Difficult

Financial markets can channel funds from savers and investors looking for productive investment opportunities to borrowers who have productive investment opportunities but not the funds to pursue them. By serving this financial intermediation function, financial markets can contribute to higher production and efficiency in the economy. Banks and other financial institutions can facilitate transactions between savers and borrowers and reduce the associated costs, as well as provide other financial services and products that contribute to economic growth.[128]

[126]Dodd-Frank Act, § 1075, 124 Stat. at 2068, *codified at* 15 U.S.C. § 1693o-2; 77 Fed. Reg. 46,258 (Aug. 3, 2012). When a consumer uses a debit card to make an electronic purchase, the merchant does not receive the full purchase amount. Part of the amount (called the merchant discount fee) is deducted and distributed among the merchant's bank, debit card issuer, and payment card network processing the transaction. Historically, the majority of the merchant discount fee was paid from the merchant's bank to the debit card issuer in the form of an interchange fee.

[127]See GAO-13-101 and GAO-12-881.

[128]Financial institutions can help contribute to economic growth by providing financial products and services to businesses and households. For example, they lend funds; transform credits with short term maturities into credits with long-term maturities; provide payment services, investment vehicles, and risk management; and support the functioning of financial markets.

However, according to academics and industry representatives, by imposing higher costs on financial institutions, the Dodd-Frank Act may indirectly impose higher costs on businesses and households and reduce their investment and consumption with a consequent effect on economic output.

Industry representatives, academics, and others generally expect the costs imposed by the act on the economy to be more significant than the act's compliance costs for regulated institutions. At the same time, experts have noted that such costs can be viewed as part of the price to pay to realize the act's potential financial stability and other benefits. For example, reforms that increase safety margins in the financial system—such as by requiring increased capital and collateral to absorb potential losses—represent a tradeoff between lower economic growth in the short term and a lower probability of a financial crisis in the long term. Furthermore, reforms may cause financial market participants to internalize costs that their failure could impose on others through, for example, triggering declines in asset prices and strains in funding markets; thus, such reforms could improve overall economic outcomes. Nevertheless, experts continue to debate whether the economic costs of the act's reforms, individually and cumulatively, could be excessive relative to their potential benefits.

One way through which the Dodd-Frank Act could impose costs on the broader economy is through its reforms that ultimately increase the cost or reduce the availability of credit for households and businesses. All else equal, when credit becomes more expensive or harder to obtain, households may reduce purchases and businesses may reduce investments that are funded by debt. These declines in consumption and investment can reduce GDP. According to academics, industry associations and firms, and others, reforms that could increase the cost or reduce the availability of credit include higher capital and liquidity requirements for financial institutions, the Volcker rule, counterparty credit limits, and mortgage-related provisions.[129]

[129]As discussed earlier in this report, some experts noted that mortgage and related credit instruments were not accurately priced before the crisis to reflect their risks. As a result, the economy experienced a credit bubble that facilitated a misallocation of resources to the housing sector. To the extent that the act's reforms contribute to a more accurate pricing of credit, the economy could benefit from a more efficient allocation of resources.

- **Capital and liquidity requirements:** Higher capital and liquidity requirements for banks can increase their funding and other costs. While banks can respond to these additional costs in a variety of ways, they generally are expected to pass on some of these costs to borrowers by charging higher interest rates on their loans, which could lead to a reduction in output. Some studies have assessed the potential short-term and long-term cost impacts of higher capital and liquidity requirements. Differences in estimates produced by different studies follow from differences in key modeling assumptions.[130] With respect to short-term impacts, studies generally suggest that increasing capital and liquidity requirements for banks will likely be associated with short-term increases in interest rates for borrowers and short-term decreases in lending volumes, output, and economic growth rates during the period over which banks transition to these new requirements, but the magnitudes vary considerably across studies. For example, a Macroeconomic Assessment Group study summarized research by its members on the impact of the transition to the Basel III capital and liquidity requirements and found that interest rates for borrowers are likely to increase and lending volumes are likely to fall during the transition period, but that the ultimate

[130]One key assumption is the choice of baseline levels of capital and liquidity against which changes attributed to financial regulatory reforms are measured. Selecting precrisis levels of capital and liquidity as a baseline could lead to overestimated costs due to financial reforms if financial institutions would have increased capital and liquidity in the absence of such reforms based on lessons learned from the crisis. Other key assumptions relate to the length of the transition period, the responsiveness of bank equity and debt prices to changes in banks' capital and liquidity levels, the responsiveness of lending rates to changes in banks' funding costs, and the extent to which monetary policy can be used to offset any upward pressure on lending rates. For additional discussion of key assumptions that impact estimates of the costs of the act's reforms, see Santos and Elliott, *Estimating the Costs of Financial Regulation,* IMF Staff Discussion Note, September 11, 2012.

reductions in output and growth are likely to be modest.[131] Studies from the IMF and the Organization for Economic Cooperation and Development found broadly similar results.[132] In contrast, a study by the Institute of International Finance estimated the impact of banks' making the transition to meeting Basel III and additional country-specific requirements and found much larger short-term impacts on lending rates, lending volumes, output, and growth rates during the transition period.[133] Studies also suggest that increasing capital and liquidity requirements for banks will likely be associated with long-term or permanent changes in lending rates and output. For example, a Basel Committee working group assessed the long-term impact of higher capital and liquidity requirements and found that they are likely to be associated with modest long-term increases in lending spreads and modest long-term reductions in output.[134] An IMF study found similar results.[135]

- **Volcker rule:** Some experts and industry representatives have expressed concern that the Volcker rule's restriction on proprietary

[131]This study estimated that a 1 percentage point increase in the target ratio of tangible common equity to risk-weighted assets would lead to a maximum decline in the level of GDP of about 0.19 percent from the baseline path, which would occur 4 ½ years after the start of implementation (equivalent to a reduction in the annual growth rate of 0.04 percentage points over this period), followed by a gradual recovery of growth towards the baseline. See Macroeconomic Assessment Group, *Interim Report: Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, Bank for International Settlements, (Basel, Switzerland: August 2010), and Macroeconomic Assessment Group, *Final Report: Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, Bank for International Settlements, (Basel, Switzerland: December 2010). The Macroeconomic Assessment Group was established by the Financial Stability Board and the Basel Committee on Banking Supervision and includes central banks and banking regulators from 15 countries, as well as several multilateral organizations.

[132]See Scott Roger and Francis Vitek, *The Global Macroeconomic Costs of Raising Bank Capital Adequacy Requirements*, IMF Working Paper WP/12/44, February 2012, and Patrick Slovik and Boris Cournède, *Macroeconomic Impact of Basel III*, OECD Economics Department Working Paper No. 844, OECD Publishing, 2011.

[133]See Institute of International Finance, *The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework*, September 2011.

[134]Basel Committee on Banking Supervision, *An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements*, Bank for International Settlements (Basel Switzerland: August 2010).

[135]Santos and Elliott, *Estimating the Costs of Financial Regulation.*

trading by banks could reduce market liquidity and increase the cost of raising funds in the securities markets and thus reduce output. As we previously reported, some market observers maintain that restrictions on proprietary trading by banks under the Volcker rule may reduce the amount of liquidity in the securities markets, depending on how the restrictions are implemented.[136] For example, the rule could reduce the amount of market-making provided by banks for certain debt securities and ultimately result in higher borrowing rates for corporations, state and local governments, or others that use debt securities to help finance their activities.[137] A study sponsored by an industry association estimated that the Volcker rule could increase annual borrowing costs for debt securities issuers by billions of dollars, and reduce liquidity in a wide range of markets, and consequently, to some extent, impede the ability of businesses to access capital through increases in cost of funds to borrowers.[138] However, other experts have asserted that the study's estimate is too high, in part because they believe it understates the potential for other firms to fill the gap left by banks and provide liquidity to the market.

- **Single counterparty credit limit:** According to industry representatives, the Federal Reserve's proposed single counterparty credit limit rule could restrict the ability of SIFIs to engage in derivatives transactions with each other to hedge risk. In turn, such interference could reduce market liquidity and result in higher funding, hedging, and transaction costs for businesses.

- **Mortgage-related reforms:** The act's provisions regulating the underwriting of mortgages also could restrict the availability of mortgage loans and raise mortgage costs for some homebuyers.[139]

[136]GAO-11-529.

[137]For example, industry groups have expressed concern that strict enforcement of the Volcker rule could cause banks to reduce or withdraw from client-driven trading activities, such as making markets in certain securities (which entails standing ready to buy and sell a security from a client even when there is no other client to take the opposite side of the trade) and providing hedging services to clients. While some have attempted to estimate the impacts of the Volcker rule, these estimates are based on assumptions about how it will be implemented, which may differ significantly from how it is actually implemented.

[138]Oliver Wyman, "The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity" (Feb. 2012).

[139]GAO, *Mortgage Reform: Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market*, GAO-11-656 (Washington, D.C.: July 19, 2011).

For example, the act amends the Truth in Lending Act to prohibit lenders from making mortgage loans without regard to borrowers' ability to repay them. As described earlier in this report, lenders may comply with the ability-to-repay standard by originating qualified mortgages that meet criteria that will be finalized by CFPB in rulemaking. In addition, securitized mortgages that meet certain criteria and which are referred to as "qualified residential mortgages" (QRM), are exempt from the act's risk retention requirements. While there is general agreement that new Dodd-Frank rules should restrict certain types of risky loans and loan products that proliferated in the lead-up to the crisis, many market observers have expressed concern that these restrictions could go too far. For example, some mortgage industry representatives have raised concerns that including overly restrictive requirements for loan-to-value and debt service-to-income ratios in the qualified residential mortgage criteria could restrict the availability of mortgages to lower-income borrowers.[140]

Measuring the costs of financial regulation to the broader economy is challenging because of the multitude of intervening variables, the complexity of the global financial system, and data limitations. Many of the rules implementing the act's reforms have not been finalized, and it is difficult to predict how regulated institutions will respond to the act's reforms. For example, the extent to which regulated institutions pass on a portion of their increased costs to their customers may be impacted by competitive forces or other factors. Furthermore, even when the reforms have been fully implemented, it may not be possible to determine precisely the extent to which observed costs can be attributed to the act versus other factors, such as changes in the economy. Differences in assumptions about the appropriate baseline for comparison can lead to significant variation in estimates of the act's impacts. As discussed below, other sources of uncertainty, such as the potential for regulatory arbitrage, add to the challenges of estimating the act's potential costs.

Some of the act's reforms have the effect of transferring wealth across groups and may create economic costs if they result in resources being deployed less efficiently. For example, new assessments to fund the

[140]The loan-to-value ratio is the loan amount divided by the value of the home at mortgage origination. As the required loan-to-value ratio falls, the required borrower down payment increases. The debt-service-to-income ratio represents the percentage of a borrower's income that goes toward all recurring debt payments, including mortgage payments.

Financial Research Fund, which funds the operating costs of FSOC, OFR, and certain expenses for the implementation of the orderly liquidation activities of FDIC, represent an economic transfer from bank holding companies to the Financial Research Fund. In addition, as noted previously, changes in the deposit insurance fund assessment base shift some of the overall assessment burden from smaller banks to the largest institutions without affecting the overall amount of assessment revenue collected. Similarly, while the Durbin amendment has reduced revenues from interchange fees for large debit card issuers, these lost revenues will be offset to some extent by financial benefits to merchants who will pay lower interchange fees. Predicting the extent to which such transfers across groups could reduce economic growth is difficult, in part because how financial institutions will respond to these changes is unclear. For example, financial institutions could respond to increased assessment burdens or reduced revenue streams by cutting other expenses or increasing fees and other costs for their customers. Some market observers have noted that some financial institutions have increased fees on certain services, such as bank checking accounts, to compensate for lost revenues and increased fee assessments from the act. However, financial institutions' business strategies are impacted by a wide range of factors, and determining the extent to which such increased fees can be attributed to the Dodd-Frank Act is difficult.

The Potential for Unintended Consequences Adds to Challenges of Assessing Benefits and Costs

Academics, industry representatives, and others we spoke with also have expressed concern about the potential for the Dodd-Frank Act's reforms to have unintended consequences that could harm U.S. economic growth or the global competitiveness of U.S. financial markets.[141] Experts have a wide range of views on the act's potential to enhance financial stability, with some maintaining that certain reforms could make the financial system more vulnerable to a crisis. For example, some experts suggest that higher capital, liquidity, and collateral requirements will cause regulated institutions to increase significantly their holdings of relatively safe and liquid securities, such as U.S. Treasuries. Such an outcome could inflate the value of such securities and result in large losses if there were a sharp correction in the securities' valuation.

[141] See, for example, Federal Financial Analytics, Inc., "Strategic Regulatory Landscape: Regulatory Intent versus Policy and Market Risk in Financial-Services Industry – Capital, Liquidity, Risk Management and Related Prudential Requirements" (October 2012).

In addition, experts raised concerns about the potential for certain reforms to cause financial activities to shift to less regulated or unregulated markets and pose risks to U.S. financial stability. Of particular concern is the potential for increased regulation of U.S. financial markets to cause financial activities in the United States to move to foreign jurisdictions with less stringent regulations. For example, some academics and industry groups contend that if the United States imposes new margin requirements on swaps before other countries, the swap business could migrate to countries with lower margin requirements. Similarly, industry representatives have raised concerns about the potential for the Volcker rule and single counterparty credit limit to disadvantage U.S. financial institutions relative to foreign competitors that will be permitted to engage in proprietary trading activities outside the United States. While acknowledging these concerns and the need for harmonizing international regulatory standards, regulators noted that it can be advantageous for the United States to be the leader in implementing new regulatory safeguards. For example, when financial institutions are more resilient to unexpected shocks, they can continue to provide loans and other financial services that are important to economic growth, even during periods of market turmoil.

These potential unintended consequences add to the challenge of assessing the costs and full impacts of the Dodd-Frank Act. Currently, the act is imposing costs on the financial services industry that could contribute to slower economic growth. At the same time, the act may help reduce the probability or severity of a future financial crisis, which would benefit the economy by preventing or mitigating crisis-related costs. However, the Dodd-Frank Act remains untested in a number of areas, has yet to be fully implemented, and leaves unresolved certain potential sources of system risk, such as money market funds and the tri-party repo market. As noted earlier, because the costs associated with a financial crisis can total trillions of dollars, the Dodd-Frank Act might need to reduce the probability of a crisis by only a small fraction for its benefits to equal its costs. Whether the act can achieve that outcome is unknown. As the impact of the act's multitude of provisions, individually or cumulatively, materializes, their benefits and costs will become more fully known and understood—enabling policy makers and regulators to revise the requirements, as needed, to achieve the appropriate balance between the act's benefits and costs to the U.S. economy.

Agency Comments

We provided a draft of this report to CFPB, CFTC, FDIC, the Federal Reserve, FSOC, OCC, OFR, Treasury, and SEC for their review and comment. We also provided excerpts of the draft report for technical comment to FHFA. All of the agencies provided technical comments, which we have incorporated, as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to CFPB, CFTC, FDIC, FHFA, the Federal Reserve, FSOC, OCC, OFR, Treasury, and SEC, interested congressional committees, members, and others. In addition, this report will be available at no charge on our web site at http://www.gao.gov.

Should you or your staff have questions concerning this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

A. Nicole Clowers
Director
Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

The objectives of our report were to examine what is known about (1) the losses and related economic impacts associated with the 2007-2009 financial crisis; (2) the benefits of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), particularly its key financial stability provisions, for the U.S. financial system and broader economy; and (3) the costs associated with the act, particularly its key financial stability provisions.

To address our first objective, we reviewed and analyzed studies by regulators and academics. We conducted searches of social science, economic, and federal research databases, including EconLit, Google Scholar, and JSTOR, to identify relevant studies that examine the losses associated with the 2007-2009 financial crisis. To help us identify relevant studies, we also relied on federal agencies and academic and other experts. Although we found these studies to be sufficiently reliable for the purposes of our report, the results should not necessarily be considered as definitive, given the potential methodological or data limitations contained in the studies individually or collectively. In addition, we reviewed our prior work that addresses economic impacts associated with the crisis, including the impacts on the fiscal challenges faced by federal, state, and local governments. We interviewed federal financial regulators, academics, industry associations, market participants and others to obtain their perspectives on how the recent financial crisis impacted the economy and what methods have been used to quantify the economic impacts associated with the crisis. Based on our literature review and interviews with experts, we identified approaches commonly used by experts to quantify or describe the economic losses associated with the crisis, and the limitations of these approaches. For example, we summarized approaches used by some researchers to quantify losses associated with the financial crisis in terms of lost gross domestic product, which measures the total goods and services produced in the economy. To describe trends in economic measures associated with the financial crisis, we collected and analyzed data from the Bureau of Economic Analysis, the Bureau of Labor Statistics, CoreLogic, the Federal Reserve Flow of Funds database, and the National Bureau of Economic Research. Lastly, we obtained and analyzed perspectives on the role of the federal government's policy interventions in mitigating the costs of the financial crisis. We obtained and analyzed data from government financial statements and other reports on the income and losses for the most significant government programs to assist the financial sector, including the Troubled Asset Relief Program, the Board of Governors of the Federal Reserve System's (Federal Reserve) emergency liquidity programs, the Temporary Liquidity Guarantee Program, and assistance

provided to rescue individual institutions, such as American International Group, Inc. and the government-sponsored enterprises. Our review did not consider the potential short-term and long-term impacts of other federal policy responses to the recession that coincided with the financial crisis, including the American Recovery and Reinvestment Act of 2009.

To address our second objective, we obtained and analyzed a broad range of perspectives on the potential economic benefits of the Dodd-Frank Act and factors that could impact the realization of these benefits. Using a literature search strategy similar to the one described under our first objective, we identified and analyzed academic and other studies that evaluate the potential benefits of one or more of the act's reforms. In addition, we reviewed relevant reports and public statements by federal financial regulators, industry associations, and others. We obtained additional perspectives from regulators, academics, and representatives of industry and public interest groups through interviews and an expert roundtable we held with the assistance of the National Academy of Sciences (NAS). Based on our literature review, interviews, and expert roundtable, we identified provisions of the act that could have the most significant impacts on financial stability, and factors that could impact the effectiveness of these provisions. In addition, we obtained and summarized expert perspectives on potential benefits of the act beyond enhanced financial stability, such as increased consumer and investor protections. Finally, we reviewed and summarized approaches used by researchers to quantify potential benefits of the act's reforms. Although we found these studies to be sufficiently reliable for the purposes of our report, the results should not necessarily be considered as definitive, given the potential methodological or data limitations contained in the studies individually or collectively.

To address our third objective, we obtained and analyzed information on the costs of implementing the Dodd-Frank Act, including for the federal government, the financial sector, and the broader economy. We obtained and summarized data on the incremental budgetary costs associated with the act's implementation for 10 federal entities (Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, Securities and Exchange Commission, Department of the Treasury, Consumer Financial Protection Bureau, Financial Stability Oversight Council, and the Office of Financial Research). We requested data on the entities' estimates of their funding and full-time equivalents agency-wide and for activities related to the Dodd-Frank Act in 2010, 2011, 2012, and 2013. We also requested

that the entities identify their sources of funding (appropriations, assessments of supervised institutions, revenue from investments or providing services, and transfers of funds from other agencies), and describe the extent to which new resources related to the Dodd-Frank Act would be funded on a one-time or recurring basis. We corroborated the information with other data, where available. In addition, we reviewed the Congressional Budget Office's estimate of the act's effect on the federal government's direct spending and revenue and, in turn, deficit. To describe the potential costs for the financial sector and the broader economy, we reviewed published works, public statements, and other available analyses by financial regulators, industry representatives, academics, and other experts. We also obtained perspectives from representatives of these groups through interviews and the expert roundtable we held in coordination with NAS. We also had two financial markets experts review a draft of our report and incorporated their comments, as appropriate.

To help inform our work on the second and third objectives, we contracted with NAS to convene a 1-day roundtable of 14 experts to discuss the potential benefits and potential costs of the Dodd-Frank Act. The group of experts was selected with the goal of obtaining a balance of perspectives and included former financial regulatory officials, representatives of financial institutions impacted by the act's reforms, academic experts on financial regulation, a representative of a public interest group, and an industry analyst. The discussion was divided into three moderated sub-sessions. The sub-sessions addressed (1) the potential benefits of the act's key financial stability reforms; (2) the potential costs of these key financial stability reforms; and (3) methodological approaches and challenges in measuring the impacts of the act's reforms. For a list of the 14 experts, see appendix III.

For parts of our methodology that involved the analysis of computer-processed data, we assessed the reliability of these data and determined that they were sufficiently reliable for our purposes. Data sets for which we conducted data reliability assessments include gross domestic product data from the Bureau of Economic Analysis; employment data from the Bureau of Labor Statistics; home price data from CoreLogic; Federal Reserve Flow of Funds data on retirement fund assets; loan default and foreclosure data from the Mortgage Bankers Association; and recession data from the National Bureau of Economic Research. We reviewed information on the statistical collection procedures and methods for these data sets to assess their reliability. In addition, we assessed the reliability of estimates federal entities provided for the funding resources

and full-time equivalents associated with Dodd-Frank implementation by comparing these estimates to agency budget documents and interviewing agency staff about how the data were collected. Finally, for studies that present quantitative estimates of the economic impacts associated with financial crises or financial regulatory reforms, we assessed the reasonableness of the methodological approaches used to generate these estimates. Although we found certain studies to be sufficiently reliable for the purposes of our report, the results should not necessarily be considered definitive, given the potential methodological or data limitations contained in the studies, individually or collectively.

We conducted this performance audit from November 2011 to January 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: International Financial Reform Efforts

Many U.S. financial firms conduct business around the world and thus generally are subject to rules on banking, securities, and other financial market activities in multiple jurisdictions. In response to the financial crisis that began in 2007, the United States and other countries have taken steps to introduce financial reforms into their domestic legal and regulatory systems. In parallel with these domestic reform efforts, international organizations have issued new standards and principles to guide their members' efforts. The goal of these international efforts is to harmonize and coordinate views and policies across different jurisdictions to minimize opportunities for regulatory arbitrage—the ability of market participants to profit from differences in regulatory regimes between one jurisdiction and another.

Examples of some of these efforts include the following:

- The G20, a group that represents 20 of the largest global economies, created the Financial Stability Board (FSB) to coordinate and monitor international financial regulatory reform efforts, among other activities.
- The Basel Committee on Banking Supervision (BCBS)—hosted at the Bank for International Settlements (BIS)—has developed a new set of capital and, for the first time, liquidity requirements for banks.
- The Committee on Payment and Settlement Systems (CPSS), which is comprised of central banks, focuses on the efficiency and stability of payment, clearing, and settlement arrangements, including financial market infrastructures. Recently, CPSS has worked jointly with the International Organization of Securities Commissions (IOSCO) to produce a new set of prudential standards for financial market infrastructures.
- IOSCO, a multilateral organization of securities market regulators, has issued policy documents to guide national securities commissions' regulatory reform efforts.
- Various other forums and groups, including the International Association of Insurance Supervisors (IAIS), are housed at BIS and cooperate on financial regulatory reform initiatives. For example, the Joint Forum—which includes representatives of IAIS, BCBS, and IOSCO—works to coordinate financial services reforms.
- Separately, multilateral organizations, such as the International Monetary Fund and Organization for Economic Cooperation and

Development, have published research and analysis of international financial reforms.

Table 5 summarizes selected international financial regulatory reform efforts.

Table 5: Selected Organizations Engaged in Coordination of International Financial Regulatory Reform Efforts

Organization	Sector	Membership	Purpose	Activities
FSB[a]	Multiple	Finance and central bank officials from members of the G20 as well as representatives of other international economic and financial standard-setting organizations[b]	International coordination of national financial authorities and international standard-setting bodies Development and promotion of effective regulatory, supervisory, and other financial sector policies	Establish principles for financial regulatory reform Monitor implementation of financial regulatory reforms, issue progress reports
BIS	Banking	Central banks or monetary authorities of 59 economies plus the European Central Bank[c]	Forum for international cooperation among central banks and within financial and supervisory communities Acts as a bank for central banks	Publishes economic and monetary research Counterparty for central banks in their financial transactions Agent or trustee in connection with international financial operations Hosts other international financial organizations and groups
BCBS[a]	Banking	Central bank or bank supervisory officials representing 27 economies[d]	Forum for cooperation on issues related to banking supervision	Establishes capital and liquidity standards for member banking systems
CPSS[a]	Banking	Central banks' payment and settlement officials	Monitor and analyze developments in domestic, cross-border, and multicurrency payment, settlement, and clearing systems	Sets standards for payment, clearing, and settlement systems
IOSCO	Securities	Securities regulatory officials from more than 100 jurisdictions	Forum for international cooperation among securities regulators	Facilitates standard setting Offers technical assistance
IAIS[a]	Insurance	Insurance regulators and supervisors from more than 190 jurisdictions[e]	Forum for global insurance supervision	Establishes principles, standards, and guidance; works with other counterparts to promote financial stability

Source: GAO summary information collected from each organization's web site.

[a]Hosted at the Bank for International Settlements.

[b]FSB member economies: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Republic of Korea, Russia, Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United

States. FSB Member organizations: Bank for International Settlements, European Central Bank, European Commission, International Monetary Fund, Organization for Economic Cooperation and Development, and The World Bank. Other FSB member groupings: Basel Committee on Banking Supervision, Committee on the Global Financial System, Committee on Payment and Settlement Systems, International Association of Insurance Supervisors, International Accounting Standards Board, and the International Organization of Securities Commissions.

[c]BIS member central banks: Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Macedonia (FYR), Malaysia, Mexico, the Netherlands, New Zealand, Norway, Peru, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Arab Emirates, the United Kingdom and the United States, plus the European Central Bank.

[d]BCBS member economies: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

[e]Insurance professionals participate as observers in some activities.

Appendix III: Experts Participating in the GAO Roundtable on the Benefits and Costs of the Dodd-Frank Act

Eric Baggesen, California Public Employees' Retirement System

Sheila Bair, The Pew Charitable Trusts

Robert Bliss, Wake Forest University

Charles Calomiris, Columbia University

Athanassios Diplas, Deutsche Bank

Douglas Elliott, The Brookings Institution

Peter Fisher, BlackRock

Sandra Lawson, Goldman Sachs

Annette Nazareth, Davis, Polk, and Wardwell, LLP

Karen Shaw Petrou, Federal Financial Analytics

Matthew Richardson, New York University

Marcus Stanley, Americans for Financial Reform

Steve Strongin, Goldman Sachs

Paul Volcker, Former Chairman of the Board of Governors of the Federal Reserve System

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

A. Nicole Clowers, (202) 512-8678 or clowersa@gao.gov

Staff Acknowledgments

In addition to the contact named above, Richard Tsuhara (Assistant Director), William R. Chatlos, John Fisher, Catherine Gelb, G. Michael Mikota, Marc Molino, Courtney LaFountain, Robert Pollard, Jennifer Schwartz, Andrew J. Stephens, and Walter Vance made significant contributions to this report.

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Bank Environment and its Impact on Company

Sep 2010
- Top ten Bank A asks to move ACH business; concerned about regulatory scrutiny – eventually forced to have redundancies with 4 ACH banks to minimize risk.

Dec 2010
- Top ten Bank B reverses decision to increase credit commitment and potentially agent credit facility citing regulatory pressure.
- Top ten Bank C and top five Canadian Bank A decline entering credit despite having depository relationships citing headline risk of the industry and regulatory pressure.

Dec 2011
- Top ten Bank D declines entering credit despite a depository relationship citing senior leadership concerns on industry and regulatory pressure.
- Top ten Bank A terminates depository relationship in 220 stores citing regulatory pressure and increased compliance.

Apr 2012
- A leading non-bank lender that currently heads the Company's credit facility, expresses intent to terminate agent capacity and credit commitment at maturity citing headline risk and regulatory pressure.

Jun 2012
- Top ten Bank C reiterates it will not extend credit to the Company citing regulators' concerns.

Apr 2013
- Small Bank A, utilized for merchant card processing, terminates relationship based on regulatory scrutiny on industry.

Aug 2013
- Small Bank B, utilized for merchant card processing, terminates relationship with Company citing regulatory pressure. Ten day notice given to move the business.

Sep 2013
- CSO lenders lose access to traditional bank financed facilities as small Bank C and top ten Bank B terminate relationships with CSOs.

Nov 2013
- Top ten Bank C terminates depository relationship in 200 stores citing headline risk and regulatory pressure.
- Top ten Bank E, currently in credit facility, declines opportunity to agent facility citing regulatory pressure.
- Top ten Bank B terminates in middle of implementation as new merchant card processor citing regulatory pressure and headline risk.

Dec 2013
- Top ten Bank B senior leadership declines to agent credit facility based on regulatory pressure.

Jan 2014
- Small Bank D cites hurdle on Company is all reputational and regulatory pressure.

Feb 2014
- Debit card processor, terminates relationship citing regulatory pressure. Gives 2 week notice.
- Small Bank E declines participation in credit facility due to regulatory pressure.

Bank Conversations That Stopped Because of Regulatory Pressure

- Aug 2010 – Small Bank F
- Sep 2010 – Small Bank G
- Dec 2010 – Small Bank H
- Jun 2012 – Small Bank I
- Sep 2013 – Top Five Canadian Bank B
- Sep 2013 – Small Bank J
- Sep 2013 – Top Ten Bank A
- Nov 2013 – Top Ten Bank C
- Nov 2013 – Top Ten Bank B Merchant Card Business
- Feb 2014 – Small Bank K Merchant Card Business
- Feb 2014 – Small Bank L Merchant Card Business

[redacted]

From:	[redacted]
Sent:	Monday, February 03, 2014 8:16 AM
To:	[redacted]
Subject:	Thank You

Gentlemen, thank you for taking the time to update us on Friday.

In spite of the strange market and excessive scrutiny, you have done very well.
Congratulations.

I wanted to thank you for your loyalty.
I know you had options other than [redacted]
Thanks for staying with us.

Based on your performance, there's NO WAY we SHOULDN'T be a credit provider.
Our only issue is, and it has always been, the space in which you operate.
It has never been the service that you've provided or the way you operate.
You've obviously done a brilliant job.
It is the scrutiny that you, AND NOW THAT WE, are under.

We'd like to stay in touch.
I promise we will keep an open mind.
Thanks again.

[redacted]
Executive Vice President and Manager

[redacted]

[redacted]

March 18, 2014

Dear

[redacted] recently performed an industry review to evaluate risk characteristics associated with typical customers as well as industry trends. Such a review can result in decisions to modify policies or controls, set concentration limits or exit an industry outside our risk tolerance.

During recent reviews of the payday lending industry, we have determined that the services provided by clients in this industry are outside of our risk tolerance. As such, we will no longer be able to provide financial services to businesses that operate in that industry. This decision impacts your business and will necessitate the closing of your accounts.

Next Steps
The complexity of closing your [redacted] accounts and transitioning services is unique to your situation, and [redacted] is committed to helping you through this transition. This work will need to begin immediately. Our intention is to exit the business relationships by June 30, 2014. We understand that in some cases, the complexity of services may require a longer exit timeline

We will work with you to schedule a meeting in the coming days to formalize the transition plan.

Sincerely,

[redacted]

[redacted]

March 03, 2014

Subject: Termination of Deposit Account(s) and Treasury Management Relationship

Last 4 digits of account(s):

Dear Customer

[redacted] performs ongoing reviews of its account relationships in connection with the Bank's responsibilities to oversee its banking operations. After careful review, a business decision has been made to close your account(s) referenced above and terminate all related Treasury Management services (e.g. ACH origination services) associated with the above accounts.

We are writing today to let you know that the account(s) and related Treasury Management services and agreements will be terminated on **May 6, 2014.** We apologize for any inconvenience that this change may cause you. Please use this time period to make alternative banking arrangements with another financial institution.

As you make your alternative arrangements, please keep the following in mind:

- Following closure of the above mentioned account(s), a cashier's check for all remaining collected and available funds in the referenced account(s) will be mailed to the last address of record for your company within ten (10) business days of the date the account is closed. Uncollected funds, if any, will be forwarded after collection. Any related products or services associated with this account will also be closed.

- On the account closure date, monetary transactions on the account(s) will be blocked. This means:
  - Up until **May 6, 2014**, no checks or other orders of withdrawal presented for payment will be paid unless the account in question at the time of presentment contains sufficient collected and available funds to cover the checks or orders of withdrawal presented at the time. Checks drawn on your account which are present after **May 6, 2014** will be returned unpaid.
  - If any funds are directly deposited to this account, these deposits will no longer be accepted after the account is closed.
  - Any automatic payments from this account will be discontinued as of **May 6, 2014.**

If you have any questions, please contact your Business relationship manager.

Sincerely,

[redacted]

03/13/2014 10:26 [redacted] PAGE 01/01

February 26, 2014

Subject: Notification of Account Closure(s) ending in:

Dear,

We are unable to effectively manage your Account(s) on a level consistent with the heightened scrutiny required by our regulators for money service businesses due to the transactional characteristics of your business.

For this reason, please be advised that [redacted] is hereby exercising its contractual right, as set forth in the Terms and Conditions of the governing Deposit Agreement, to close the above referenced Account effective thirty (30) days from the date of this letter. Accordingly, we request that you accept this letter as official notification that [redacted] will no longer host the referenced Account(s). Please make the necessary arrangements to establish other banking relationships so the closing of this Account(s) will not unduly inconvenience you.

Any funds remaining in the Account(s) after the thirtieth day will be mailed to you at the address listed on the Account(s). Closing of the Account(s) does not release you from the payment of accrued fees or for other obligations incurred before closing (including obligations incurred in the process of closing out the Account(s), or for your liability on outstanding items.

We expect that this will provide you with sufficient time to move the Account(s) to another financial institution.

Your cooperation in this matter is appreciated.

Respectfully,

[redacted]

Member FDIC

[redacted]

[redacted]

[redacted]

Date
January 14, 2014

[redacted]

Your Small Business account will be closed on March 14, 2014, and we want you to be able to plan ahead.

Account ending in:

We take a proactive approach to reviewing our customers' accounts. Most recently, we reviewed the nature of your business in light of current regulatory trends affecting your industry. After careful consideration we've decided to close your existing Small Business checking account listed to the right on March 14, 2014. We are giving you time to prepare. If you prefer, you can close your account prior to this date

Your Deposit Agreement and disclosures, provided to you when your account was opened, state that the account may be closed by you or us at any time

What you can expect

After your closing date of March 14, 2014, we'll mail you a cashier's check for the remaining balance in your account The check will be mailed to the address we have on file within 5 business days of account closure

What you need to know

Any checks you've written on your Small Business checking account that are presented for payment after the account is closed will be returned unpaid. In addition, your debit card will no longer access your account after it is closed.

If your account is or becomes overdrawn, you must deposit enough cash to bring the account to a zero balance

You'll want to make other payment arrangements to any merchants or service providers that you're currently paying electronically through an automated payment.

If you have a Small Business Credit Card, you will receive a separate notice regarding the status of that account.

Questions?

Please call us with any questions at [redacted] Monday through Friday from 8 a.m. to 8 p.m. Eastern and Saturday from 8 a.m. to 5 p.m. Eastern.

[redacted]

[redacted]

FDIC

Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-43-2013
September 27, 2013

FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities

Summary: The FDIC is clarifying its policy and supervisory approach related to facilitating payment processing services directly, or indirectly through a third party, for merchant customers engaged in higher-risk activities. Facilitating payment processing for merchant customers engaged in higher-risk activities can pose risks to financial institutions; however, those that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing services to customers operating in compliance with applicable law.

Statement of Applicability to Institutions With Total Assets Under $1 Billion: This Financial Institution Letter applies to all FDIC-supervised banks and savings associations, including community institutions.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:
Board of Directors, Senior Executive Officers, Chief Credit Officer, Chief Information Technology Officer, Bank Secrecy Act Officer

Related Topics:
Guidance for Managing Third-Party Risk, FIL-44-2008;
Guidance on Payment Processor Relationships, FIL-127-2009;
Managing Risks in Third-Party Payment Processor Relationships, Supervisory Insights Journal, Summer 2011;
Payment Processor Relationships, Revised Guidance, FIL-3-2012;
FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual; and
FFIEC Information Technology Hand book, Retail Payments Systems Booklet.

Attachment:
FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities

Contacts:
Michael Benardo, Section Chief, Division of Risk Management Supervision at MBenardo@FDIC.gov or 703-254-0450; Surge Sen, Section Chief, Division of Depositor and Consumer Protection at SSen@FDIC.gov or 202-898-6699

Note:
FDIC Financial Institution Letters (FILs) may be accessed from the FDIC's Web site at http://www.fdic.gov/news/news/financial/2013/index.html.

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Paper copies may be obtained via the FDIC's Public Information Center, 3501 Fairfax Drive, E-1002, Arlington, VA 22226 (877-275-3342 or 703-562-2200).

Highlights:

- Financial institutions that provide payment processing services directly or indirectly for merchant customers engaged in higher-risk activities are expected to perform proper risk assessments, conduct due diligence to determine merchant customers are operating in accordance with applicable law, and maintain systems to monitor relationships over time.
- Proper management of relationships with merchant customers engaged in higher-risk activities is essential. Financial institutions need to assure themselves that they are not facilitating fraudulent or other illegal activity. Institutions could be exposed to financial or legal risk should the legality of activities be challenged.
- FDIC's examination focus is on assessing whether financial institutions are adequately overseeing activities and transactions they process and appropriately managing and mitigating risks. Financial institutions that have appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law.

FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities

The FDIC is issuing this letter to clarify its policy and supervisory approach related to facilitating payment processing[1] services directly, or indirectly through a third party, for merchant customers engaged in higher-risk activities.[2] Facilitating payment processing for merchant customers engaged in higher-risk activities can pose risks to financial institutions and requires due diligence and monitoring, as detailed in prior FDIC and interagency guidance and other information.[3] Financial institutions that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing services to customers operating in compliance with applicable federal and state law.

The FDIC and other agency guidance indicate that financial institutions that provide payment processing services directly or indirectly for merchants engaged in higher-risk activities are expected to perform proper risk assessments, conduct due diligence sufficient to ascertain that the merchants are operating in accordance with applicable law, and maintain appropriate systems to monitor these relationships over time. The proper management of relationships with merchant customers engaged in higher-risk activities is essential. Financial institutions need to assure themselves that they are not facilitating fraudulent or other illegal activity. Institutions could be exposed to financial or legal risk should the legality of activities be challenged.

The FDIC is aware that some payment processors or merchants may target institutions that are unfamiliar with the related risks or that lack proper due diligence or controls to manage these risks. Thus financial institutions that engage or plan to engage in these activities should review this guidance. The focus of FDIC examinations is to assess whether financial institutions are adequately overseeing activities and transactions they process and appropriately managing and mitigating related risks. Those that are operating with the appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law.

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[1] Payments may be in the form of remotely created checks (also known as "Demand Drafts"), Automated Clearing House transactions, or similar methods.

[2] Higher-risk activities are those that tend to display a higher incidence of consumer fraud or potentially illegal activities than some other businesses. Higher-risk activities are typically characterized by high rates of return, high rates of unauthorized transactions, consumer complaints, or evidence of state or federal regulatory or criminal actions against the business customer, which indicate that the activity needs to be reviewed to determine whether fraudulent or illegal activity is occurring. See FDIC, Financial Institution Letter, FIL-3-2012, *Payment Processor Relationships, Revised Guidance* issued January 2012.

[3] FDIC guidance and other information on this topic includes:

- Financial Institution Letter, FIL-44-2008, *Guidance for Managing Third-Party Risk* issued June 2008.
- Financial Institution Letter, FIL-127-2008, *Guidance on Payment Processor Relationships* issued November 2008.
- *Managing Risks in Third-Party Payment Processor Relationships* Summer 2011 Supervisory Insights Journal.
- Financial Institution Letter, FIL-3-2012, *Payment Processor Relationships, Revised Guidance* issued January 2012.

FFIEC guidance on this topic includes:

- The *FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual*.
- *The FFIEC Information Technology Handbook*, "Retail Payments Systems Booklet."

FINANCIAL SERVICES ROUNDTABLE

THE FINANCIAL SERVICES ROUNDTABLE

Committee on Financial Services Hearing

"Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

April 8, 2014

Mr. Chairman, Ranking Member Waters, Members of the Committee, thank you for offering the Financial Services Roundtable[1] the opportunity to present our views for the record at your hearing entitled: "Who's In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom."

The member institutions of FSR believe strongly that there is a proper role for regulation in the financial services sector, to protect consumers and to protect the entire financial system. There are, however, regulatory burdens that pressure our members to stop offering financial products that are safe for our institutions, and provide a needed service for our customers.

The proper level of regulatory oversight across of the financial regulatory system is obviously a matter of considerable debate, but it is clear that some agencies have taken a more aggressive posture than others. Overly prescriptive regulatory actions have led to the disappearance of a variety of consumer products, and we would like to take this opportunity to discuss a few of them.

Credit monitoring services offered by financial institutions

Credit monitoring services are used by millions of consumers to meet their needs for peace of mind and protection against fraud and identity theft. Instead of first using its supervisory and regulatory authority to engage in a public dialogue with consumers and financial services companies about credit monitoring, the Consumer Financial Protection Bureau (CFPB) used its enforcement authority to discourage financial institutions from marketing credit monitoring products to their customers. As a result, consumers will find that a service they wanted is no longer readily available from their financial institution.

Low-balance short-term lending and free checking

In addition, small dollar short-term lending by financial institutions has virtually disappeared. As a result of guidance issued by banking regulators and public statements by the CFPB, consumers are losing access to the more affordable short term lending products offered by financial institutions and having to turn to other forms of short-term and low-balance loan products, often from entities outside the regulated banking system.

Some have said that they believe that financial institutions should be able to make short-term credit available to low-balance borrowers for under the legal APR of 36% per year. This belief is not supported by fact. If institutions could profitably make these loans, they would. In fact, if there was a long-term benefit to a company, such as by using such loans as loss-leaders, institutions would offer it. But unfortunately, in the current regulatory environment, it is simply not profitable in the short or long run.

Not too long ago, free checking was available to most banking customers. Now, it is a rarely encountered product for individuals with low-balance accounts. Overdraft protection, where a

[1] The Financial Services Roundtable (FSR) is the leading advocacy organization for America's financial services industry. FSR members include the leading banking, insurance, asset management, finance and credit card companies in America. FSR is a CEO level organization, giving us a unique perspective on the market.

bank would pay a check even if there were insufficient funds, was a service of great value to many customers. Now, that service is no longer available to most low-balance customers. The reason these products are not available is because of the regulatory risk to the financial institution.

These products allowed customers to bridge gaps in their financial circumstances, needs that are especially acute in times of economic uncertainty. Financial institutions that offered these services uniformly reported high customer satisfaction scores. Customers liked the lower cost, convenient access to credit, flexible repayment options, and the fact "their bank" offered the as reasons for their satisfaction.

For all practical purposes, the guidance that the OCC and FDIC issued in November 2013 effectively closed the door on financial institutions offering deposit advance and similar products. One financial institution estimated that more than 90% of the customers enrolled in its product would not qualify once the underwriting, cash flow analysis and recurring re-qualification criteria required by the regulatory guidance took effect.

Remittances

The CFPB's final rule on remittances has likely reduced availability and increased costs for consumers seeking to remit money across borders. Although CFPB made some accommodations in their final rule in the face of industry and consumer concerns, the cost of compliance is expected to increase prices and reduce the number of financial institutions that offer remittance services.

Impact of disparate impact tests on insurance products

The Department of Housing and Urban Development has issued a rule that shifts the test for discrimination from intent to outcome with respect to home ownership related products, including homeowners' insurance. Insurers price risk based on the property or asset, not the person or group. But this rule means that as insurers price risk appropriately, they may be subject to legal action based on the outcome of pricing that risk.

The insurance sector is opposed to housing discrimination on the basis of race, national origin, religion, sex, familial status, or handicap. And state insurance rating and underwriting laws specifically prohibit the use of those factors. This rule fails to take into account that the long-standing state-based insurance regulatory structure protects consumers by requiring that homeowner insurance rates not be excessive, inadequate or unfairly discriminatory. The rule creates a dual, incompatible standard that threatens the risk-based model for insurance underwriting and rating, and upends the state-based compliance structure.

Impact of Ability to Repay/Qualified Mortgage Regulation on credit availability

Our members continue to be concerned about the potential impact of the Ability to Repay/Qualified Mortgage Regulation on credit availability. While the regulation has only been in effect since January, it is causing lenders to utilize more conservative underwriting standards

to ensure they are within the QM parameters. This has the potential to limit availability to some borrowers who may be worthy credit candidates. Until the full impact of QM is understood and assessed, the regulatory impact will be to put more pressure to limit credit availability."

The big picture

We believe that regulators and the Congress need to step back and consider the impact of all of these rules in aggregate. Somebody needs to take the full picture of what is happening in the market.

Financial institutions will always be able to make a profit on large balance customers. The goal of public policy should be to bring more customers into the banking system and to offer more innovation and choices to our customers. Unfortunately, the regulatory environment we are seeing develop is actually pushing people out of the banking system and is limiting the creation of new products and services.

Thank you for holding this important hearing and for the opportunity to submit testimony for the record.

Congress of the United States
Washington, DC 20515

August 22, 2013

The Honorable Eric Holder
Attorney General
U.S. Department of Justice
950 Pennsylvania Avenue, NW
Washington, D.C. 20530

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Commission
550 17th Street, NW
Washington, D.C. 20429

Dear Attorney General Holder and Chairman Gruenberg:

It has come to our attention that the Department of Justice (DOJ) and Federal Deposit Insurance Corporation (FDIC) are leading a joint agency effort that, according to a DOJ official, is intended to "change the structures within the financial system...choking [online short-term lenders] off from the very air they need to survive."[1] Your efforts to stop banks from processing these lawful transactions would destroy many legitimate, legally compliant companies and small businesses, and adversely impact tens of millions of low-income American families who depend on short-term credit provided by online lenders because they do not qualify for traditional loans or credit cards.

More than one in four American households conducts some or all of their financial transactions outside the mainstream banking system, according to the results of the FDIC's 2011 National Survey of Unbanked and Underbanked Households. If the government cuts off underserved consumers' credit options, it will force many Americans who live paycheck-to-paycheck to turn to unregulated and unsafe alternatives that are much more expensive than currently available short-term credit products.

We are especially troubled by reports that the DOJ and FDIC are intimidating some community banks and third party payment processors with threats of heightened regulatory scrutiny unless they cease doing business with online lenders. As a result, many banks and payment processors are terminating relationships with many of their long-term customers who provide underserved consumers with short-term credit options.

We understand that, as with any industry, there are bad actors in online and nondepository lending. We support your efforts to protect consumers with disclosure rules that protect consumers by giving them full information. We also believe in strong enforcement of existing laws designed to prevent abusive lending. However, it is highly inappropriate to pre-judge an entire industry, or significant portions of it. Your current actions would eliminate the basic processing services that legitimate lenders rely upon to serve millions of Americans. A much more targeted approach is required.

---

[1] Alan Zibel and Brent Kendall, *Prosecutors Target Firms that Process Payments for Online Payday Lenders, Others*, Wall Street Journal, Aug. 8, 2013, at A1.

Regulators must be especially careful not to impose undue restrictions on online credit services because many underserved consumers find it more convenient to go online than to drive to a storefront lender, and they enjoy the convenience and privacy that only the Internet can provide. These competitive advantages have made internet lending a nationwide and global business.

Underserved consumers need more access to innovative and better-suited financial products and services, not less. Federal banking regulators such as the FDIC should focus on finding creative, realistic ways to help low-income families make ends meet, instead of cutting off access to legal online lenders.

Your actions to "choke off" short-term lenders by changing the structure of the financial system are outside your congressional mandate. With the enactment of the Dodd-Frank Act, Congress acknowledged the need for short-term credit products and did not try to limit online lender's or storefront operators' ability to offer such products.

Dodd-Frank also included a specific provision designed to prohibit the Consumer Financial Protection Bureau (CFPB) from imposing rate limitations on short-term loans. Neither Dodd-Frank, nor any other legislation passed by Congress, has given the DOJ, FDIC or any other federal agency the authority to "take away the very air" that online lenders "need to survive."

Given the threat that the overreaching actions taken by your agencies pose to low-income American families who depend on short-term, online credit to pay their bills and feed their families, we ask that you promptly suspend any activities that could deny any lawfully operating lenders access to the payments system. Additionally, we strongly encourage your agencies to immediately stop any actions designed to pressure banks and payment processors to terminate business relationships with lawful lenders.

We take the actions of your agencies very seriously and look forward to a detailed and prompt response. Additionally, we request that your agencies contact Chris Brown of Rep. Luetkemeyer's staff (ChrisBrown@mail.house.gov or 202.225.2956) or Lara Driscoe of Rep. Yoder's staff (LaraDriscoe@mail.house.gov or 202.225.2865) to arrange a staff briefing on this matter.

Thank you in advance for your consideration and timely response.

Sincerely,

Blaine Luetkemeyer
Member of Congress

Kevin Yoder
Member of Congress

Pete Sessions
Member of Congress

Patrick McHenry
Member of Congress

Spencer Bachus
Member of Congress

Steve Stivers
Member of Congress

Scott Garrett
Member of Congress

Tom Cotton
Member of Congress

David Schweikert
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U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

January 28, 2014

The Honorable Blaine Luetkemeyer
U.S. House of Representatives
Washington, DC 20515

The Honorable Kevin Yoder
U.S. House of Representatives
Washington, DC 20515

Dear Congressmen Luetkemeyer and Yoder:

This letter follows the January 9, 2014, briefing conducted by Stuart Delery, the Assistant Attorney General for the Civil Division, and ongoing conversations between your offices and the Department of Justice (the Department) on investigations targeting financial institutions and payment processors that have facilitated consumer fraud.

You and your staff have indicated concerns regarding the nature of these investigations. Assistant Attorney General Delery noted in his meeting with you that the Civil Division would reiterate the goals of our investigations to interested external parties. We therefore call your attention to the attached letter from Assistant Attorney General Delery to the American Bankers Association and the Electronic Transactions Association.

The letter reiterates that the Department does not target businesses operating within the bounds of the law. Specifically, Assistant Attorney General Delery noted that:

> The Department has no interest in pursuing or discouraging lawful conduct. Our policy is to take the steps necessary to prevent financial institutions from knowingly assisting fraudulent merchants that harm consumers or processing transactions while deliberately ignoring evidence that they are fraudulent.

To be clear, our purpose is to investigate violations of federal law, especially those involving fraudulent conduct that threatens to harm the American public. We want to protect the public from this mass-market consumer fraud by holding accountable those banks and payment processors that violate federal law by facilitating fraudulent transactions. We agree, of course, that it is important for the Department's public statements to be both consistent with this policy and sufficiently clear as to avoid any confusion on this point.

We hope this information is helpful. Please do not hesitate to contact this office if we may provide additional assistance regarding this or any other matter.

Sincerely,

Peter J. Kadzik
Principal Deputy Assistant Attorney General

Enclosure

U. S. Department of Justice

Civil Division

January 22, 2014

Mr. Jeff L. Plagge
Chairman
American Bankers Association
1120 Connecticut Avenue, NW
Washington, D.C. 20036

Mr. Jason Oxman
Chief Executive Officer
Electronic Transaction Association
1101 16th Street, NW, #402
Washington, D.C. 20036

Dear Messrs. Plagge and Oxman:

I am writing concerning an issue that may be of interest to your members, and specifically to clarify the Department of Justice's policy and approach regarding certain investigations into banks, payment processors, and other institutions that process payments for merchants engaged in fraudulent activities.

The Department of Justice is committed to protecting the American people from fraudulent practices in all industries – without exception. To the extent we have evidence that an entity is violating federal law by engaging in or facilitating fraudulent conduct, we will take appropriate measures to combat that conduct.

As you may be aware, the Department has engaged in various efforts to eliminate fraud in the payment system by holding financial services entities accountable where such entities (contrary to their responsibilities under federal law) engage in fraud or aid others who are engaging in fraud. The Department wishes to make clear that the aim of these efforts is to combat fraud. The Department has no interest in pursuing or discouraging lawful conduct. Our policy is to take the steps necessary to prevent financial institutions from knowingly assisting fraudulent merchants that harm consumers or processing transactions while deliberately ignoring evidence that they are fraudulent. It may be relevant to our inquiry that a financial institution is intentionally disregarding other obligations under federal law.

As the FDIC has recently clarified, "Facilitating payment processing for merchant customers engaged in higher risk activities can pose risks to financial institutions and requires due diligence and monitoring, as detailed in prior FDIC and interagency guidance and other information. Financial institutions that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing services to customers operating

in compliance with applicable federal and state law." FIL- 43-2013. Moreover, as the FDIC stated, "Those that are operating with the appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law." *Id.*

We share these views. The aim of our investigations is to identify and hold accountable financial institutions that are engaged in or facilitate fraud. Our policy is not to prohibit or discourage financial institutions from providing payment processing services to customers operating in compliance with applicable federal and state law, and we are committed to tailoring our investigative efforts accordingly. Finally, we will continue to review our efforts to minimize any impact and collateral consequences on institutions we are not investigating.

We look forward to further engagement with you and your colleagues concerning consumer protection issues of mutual concern.

Sincerely,

Stuart F. Delery

Stuart F. Delery
Assistant Attorney General

Congress of the United States
Washington, DC 20515

March 27, 2014

The Honorable Janet Yellen
Chair
Board of Governors of the Federal Reserve System
Constitution Avenue and 20th Street, NW
Washington, DC 20551

The Honorable Thomas J. Curry
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Dear Chair Yellen and Chairman Curry:

We write to first commend the recent efforts of federal banking and law enforcement agencies to eliminate fraud and illegal transactions from our nation's payment system. We also write to express our grave concern regarding the unintended impact of these actions on a crucial segment of our financial system, including fully licensed and regulated Money Services Businesses (MSBs) and their legitimate customers.

MSBs provide a wide array of important financial products and services. As far back as March of 2005, the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Commission (FDIC), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration, the Financial Crimes Enforcement Network, and the Office of Thrift Supervision recognized that "[t]he money services business industry provides valuable financial services, especially to individuals who may not have ready access to the formal banking sector." (Joint Statement, March 30, 2005). Furthermore, in serving millions of unbanked and underbanked consumers, MSBs are often the only providers of financial services in low- and moderate-income areas, where other financial services are not readily available or do not meet consumer needs. That is why, in part, Congress acknowledged the need for short-term credit products and did not limit the ability of online lenders or storefront operators to offer such products in the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. For example, consumers who are about to have their water or electricity turned off, and need a small short-term loan to pay their bills are not going to be able to secure it at a traditional financial institution.

Efforts to protect our constituents and American consumers as a whole from fraud must be balanced with the need to ensure access to regulated financial services and providers. MSBs operate under an extensive system of licensing, regulation, and supervision. Furthermore, at the federal level, the Consumer Financial Protection Bureau (CFPB) has supervisory authority over many of the products offered by MSBs.

It is our understanding that certain recent efforts of federal and state regulators to eliminate fraud, while laudable, have adversely impacted many legally operating MSBs and threaten many of the vital, regulated financial services they provide. We continue to hear from MSBs that are now unable to obtain basic banking services such as bank accounts and lines of credit. In addition, federal attempts to eliminate fraud from the Automated Clearing House (ACH) system have lead depository financial institutions to close access to the ACH system for licensed MSBs.

Banks that have terminated these services, either directly or through ACH processors that serve MSBs, are reflecting blanket concerns about heightened regulatory scrutiny as opposed to engaging in appropriate, risk-based determinations based on individual customer circumstances. Therefore, legitimate, licensed MSBs are being cut off from vital banking services. In turn, as a result their customers may be denied access to much needed financial products and services. Efforts to help eliminate fraud should not come at the expense of limiting access to financial services for some of our most vulnerable citizens.

It has been widely reported that FDIC and DOJ are leading a joint agency effort on this front, commonly referred to as Operation Choke Point, in which banks, including community banks, and third party payment processors face heightened regulatory scrutiny unless they cease doing business with online lenders. It has recently come to our attention that examiners from both the Fed and OCC are also playing a role in discouraging banks from processing lawful transactions, extending credit or holding accounts for MSBs. The reports we have received cause us great concern.

Members of Congress have taken action on this issue and, as a result, both DOJ and FDIC have acknowledged the inappropriate targeting of lenders and intimidation of financial institutions. Both agencies have issued clarifying documentation specifically stating that financial institutions should not be penalized or scrutinized merely for maintaining relationships – many of which are longstanding – with lenders that comply with applicable state and federal laws. Those communiqués are attached. Moreover, CFPB Director Richard Cordray has testified with regard to online lending that those acting in compliance with the law deserve protection, and we believe that it is important to share this message with your respective agencies and industry stakeholders. Likewise, we should encourage responsible insured depositories and state licensed providers who follow both state and federal law to continue to provide these vital services to our constituents."

Finally, are you supporting Operation Choke Point and if so, what if any are your respective roles?

While the determination to eliminate fraud is commendable and one that we fully support, efforts to stop banks from processing lawful transactions and maintaining financially sound accounts have the potential to destroy many legitimate, legally compliant lenders and small businesses, as well as adversely impact tens of millions of low- and moderate-income American families.

Banks should not be forced to throw out legitimate customers they have successfully banked for decades. Regulators should instead directly target predatory actors who are breaking existing laws and resist any broad approach that causes undue consequences on an entire industry. We thank you for your consideration of this matter and look forward to your prompt response.

Sincerely,

Blaine Luetkemeyer
Member of Congress

Alcee L. Hastings
Member of Congress

Kevin Yoder
Member of Congress

Joe Garcia
Member of Congress

Pete Sessions
Member of Congress

Bennie G. Thompson
Member of Congress

Lynn A. Westmoreland
Member of Congress

Gregory W. Meeks
Member of Congress

Patrick T. McHenry
Member of Congress

Tony Cardenas
Member of Congress

Dennis A. Ross
Member of Congress

Patrick E. Murphy
Member of Congress

Steve Stivers
Member of Congress

Mick Mulvaney
Member of Congress

Sean P. Duffy
Member of Congress

Robert Hurt
Member of Congress

Lynn Jenkins
Member of Congress

Stephen Fincher
Member of Congress

Wm. Lacy Clay
Member of Congress

Filemon Vela
Member of Congress

Henry Cuellar
Member of Congress

Ed Perlmutter
Member of Congress

Frederica Wilson
Member of Congress

cc: Martin J. Gruenberg, Chairman, FDIC

United States of America
v.
Payment Processing Center

A Case Study of Remotely Created Check Abuse and Payment System Vulnerabilities

Joel M. Sweet, Trial Attorney, Consumer Protection Branch, DOJ
(detailee from United States Attorney's Office for the Eastern District of Pennsylvania)

1

Disclaimer

Any opinions reflected in this presentation are those of the presenter and are not necessarily those of the Department of Justice, or any government official, agency, department, or branch.

The information in this presentation is from public sources.

2

Mass Market Consumer Fraud – a National Scourge

Bernie Madoff swindled more than $40B from a select group of mostly wealthy investors.

Fraudsters steal more than $40B from consumers – mostly the elderly and those in the lower middle class – every year!

Which is most likely to receive attention from law enforcement, regulators, and the press: a single theft of $100 million, or one million thefts of $100?

3

Common Methods of Payment System Abuse

- Debit transactions originated by payment processors and banks on behalf of telemarketing and Internet fraudsters
- Phone company bills used to originate unauthorized charges ("cramming")
- Mortgage payment mechanisms used to originate unauthorized charges

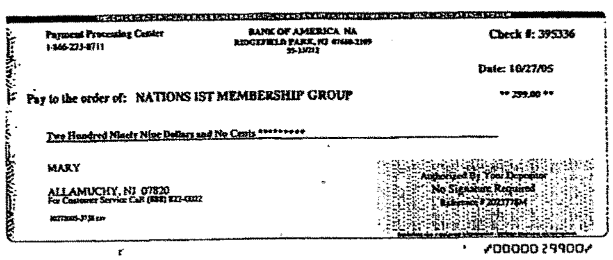
4

Law Enforcement Challenges to Prosecuting Telemarketing/Internet Fraud

- Jurisdictional limitations (state and international)
- Fraudsters change corporate identities and law enforcement plays "whack-a-mole"
- Victims are dispersed geographically
- Victims cannot identify fraudsters – no face-to-face contact
- Plausible deniability – cross-pointing among call centers, mail houses, fulfillment centers, payment processors, and banks
- Limited investigative and prosecutorial resources
- Limited reach of State Attorneys General and FTC

5

A Remotely Created Check ("RCC")


Payment Processing Center
BANK OF AMERICA NA
Check #: 395336
Date: 10/27/05
Pay to the order of: NATIONS 1ST MEMBERSHIP GROUP
** 299.00 **
Two Hundred Ninety Nine Dollars and No Cents *********
MARY
ALLAMUCHY, NJ 07820
Authorized By Your Depositor
No Signature Required
⑆00000 29900⑆

6

RCC Fraud: Well-Known to Banks

"Demand drafts can be misused to commit check fraud. This practice involves the misuse of account information to obtain funds from a person's bank account without that person's signature on a negotiable instrument. . . **demand drafts have been used by deceptive telemarketers who obtain bank account information and withdraw unauthorized funds from consumers' bank accounts**, without their realizing that such withdrawals are occurring. . . ."

A Guide to Checks and Check Fraud, published by Wachovia, 2003

7

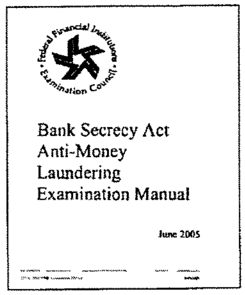
RCC Fraud: Well-Known to State Law Enforcement and FRB

- In 2005, 35 state attorneys general jointly request that the Federal Reserve ban RCCs from the payments system:
  - "demand drafts are frequently used to perpetrate fraud on consumers"
  - "such drafts should be eliminated" in favor of other forms of payment
  - If not eliminated, mandatory marking of RCCs and other measures to protect consumers

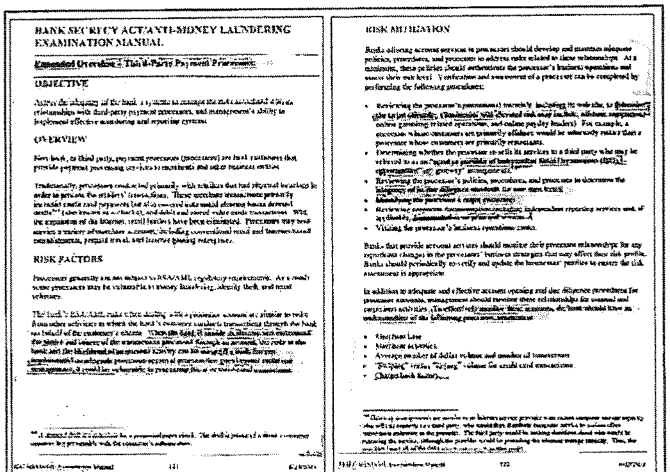
8

RCC Fraud: Well-Known to Bank Regulators

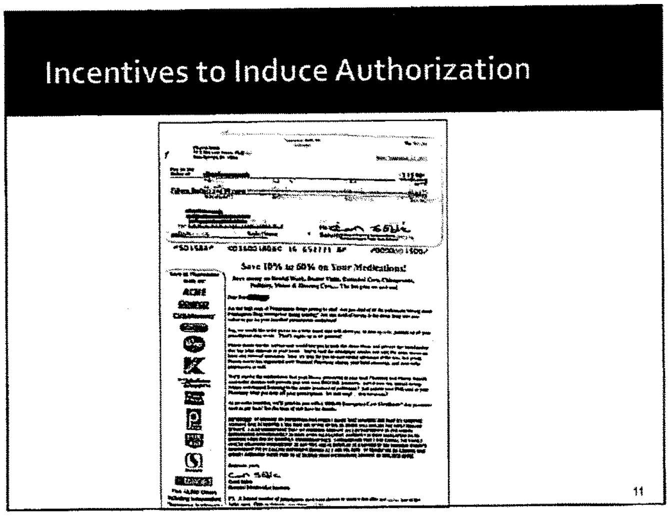
BSA/AML Examination Manual (FRB, FDIC, NCUA, OCC, and OTS)

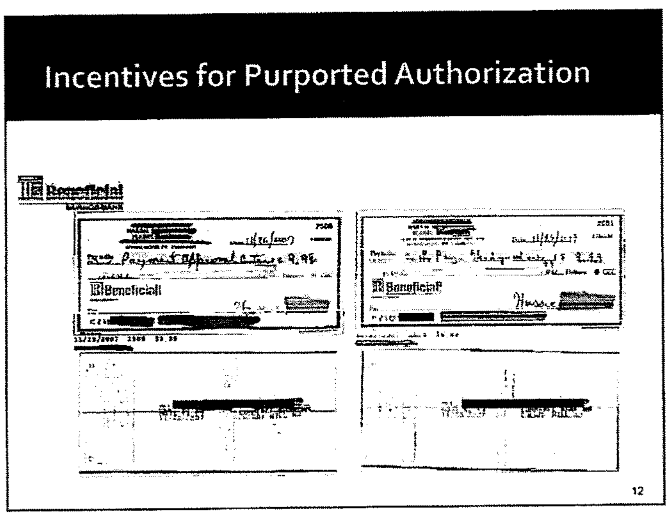


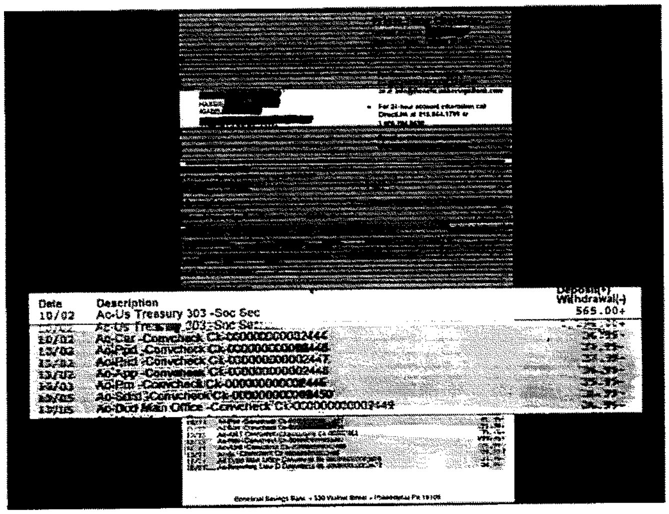
9

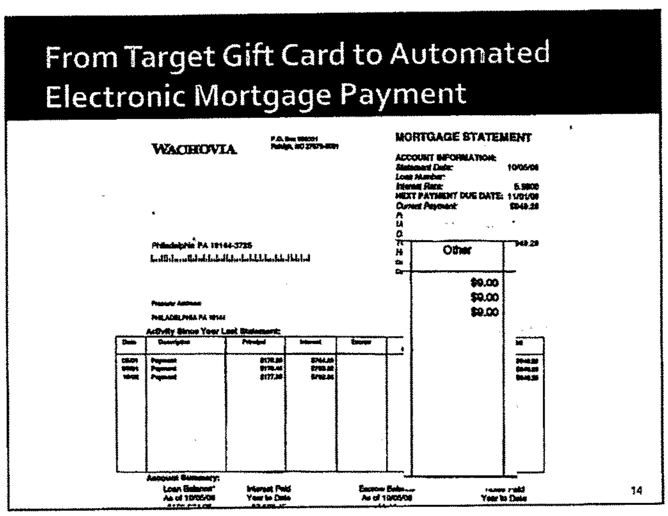


10

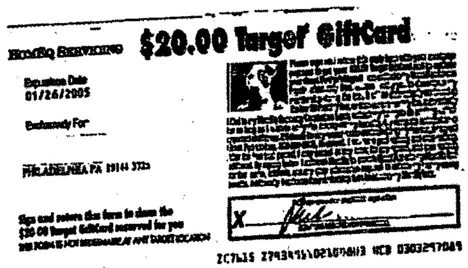

Incentives to Induce Authorization
Save 10% to 60% on Your Medications!
11


Incentives for Purported Authorization
Beneficial
12


Date
Description
Deposit(+)
Withdrawal(-)
10/02
Ac-Us Treasury 303 -Soc Sec
565.00+


From Target Gift Card to Automated Electronic Mortgage Payment
WACHOVIA
MORTGAGE STATEMENT
ACCOUNT INFORMATION:
Other
$0.00
$0.00
$0.00
14

Incentives to Induce Authorization



15

Payment Processing Center, LLC

- Provides "end-to-end solutions" for telemarketing merchants
- Specializes in "Bank Draft origination for telephone **transactions that may be prohibited**" by NACHA rules

16

[redacted]: imaqhihcbbcspbcmlilebhoaas justin@paymentprocessingcenter.com
[redacted]: 0000000353
[redacted]: 00000000D8B3FD6A785EC64E87ADC17FEBD9131424232100
[redacted]: To the fine people that made hellish phone abuse a little more bearable,

. I am glad to have shared the daily death-threats, hate-filled rants, and ignorance with all of you. I think sometime in the next couple weeks I may almost (in some kind of sick way) miss the sound of shit-kickers screamed obsenities over the verification playback.

bacon-speckled tomato soup, dealt with a phonebook's worth of customer callbacks, and a lot of soggy bread from the sandwich club.

When you come into work on Monday don't be sad that my cute little ass isn't around, be happy... because finally one of us will get to know what daylight

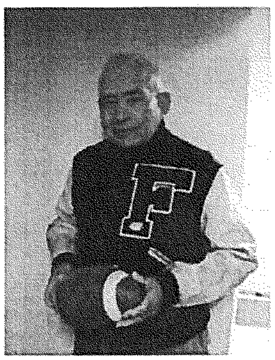
I know the customer service number and I'm not afraid to call with my bank rep on the line)

Now, as I hang up my Steno Pad and descend back in to a world of relative normality I would like to say THANK YOU to everyone.

Side note to Michael: How much exactly do I owe you for the knowledge that it takes a total of 16 combined brain cells and teeth to provide your bank account information to a stranger on the phone to order something with as stupid a name as Washballs? or; the knowledge that old people are just plain easy to trick?

stay in touch,
Justin

Purported Authorization Obtained By Telemarketer



David XXX, Sr.
1933-2006

University Football Coach

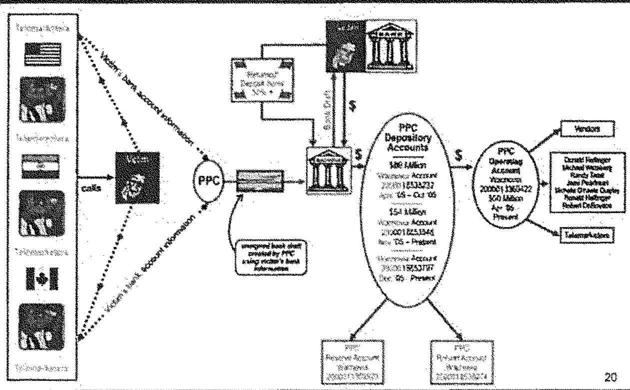
Little League Coach

Sunday School Teacher

Husband, Father, Grandfather, Brother

19

The Payment Process



20

A Mutually Profitable Relationship!

Dollar value of RCCs deposited by PPC with Wachovia in 12-month period: **$162,000,000**

Income from RCC fees:

PPC – **approx. $8,000,000**
Bank – **approx. $1,900,000**

21

Wachovia: Victim or Participant?

- Knew or remained willfully blind to fact that PPC serviced mass market fraudsters
- Ignored glaring red flags
- Suppressed internal concerns
- Ignored express warnings from other banks
- Entered agreements with PPC to protect its own interests at the expense of the interests of other banks and their customers

22

Failure in Due Diligence
PPC's Telemarketing Merchants

- Facially suspicious product offers and marketing scripts
  - Grant offers
  - Prescription discount cards
  - Travel Programs
  - Free Gift Cards
  - Free Computers
- Merchants mostly based overseas and/or using foreign banks
- Exploited names of legitimate companies, such as Wal-Mart, K-Mart, Home Depot, Carnival Cruises, AIG

23

Eyes Wide Shut

- PPC merchants were fraudsters well-known to Better Business Bureaus, state Attorneys General, and consumer protection websites
  - Star Communications
  - Advantage America
  - Suntasia
- As successive payment processers were shut down by law enforcement, Wachovia continued to process RCCs for same fraudulent merchants

24

Returns – Charge Backs

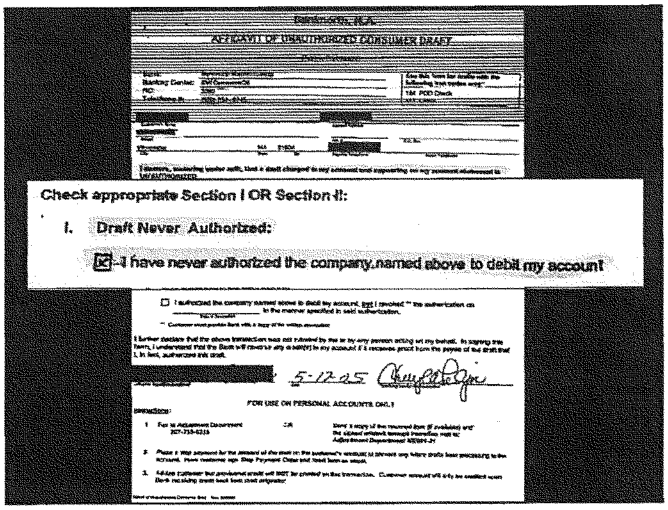
- At inception, Wachovia **anticipated returns exceeding 35 percent** (compared to approximately 1/2 of 1 percent for all checks)
- Actual returns exceeded **50 percent**
- Wachovia charged PPC substantial fee for returns
- Wachovia offered PPC volume discounts on return fees

25

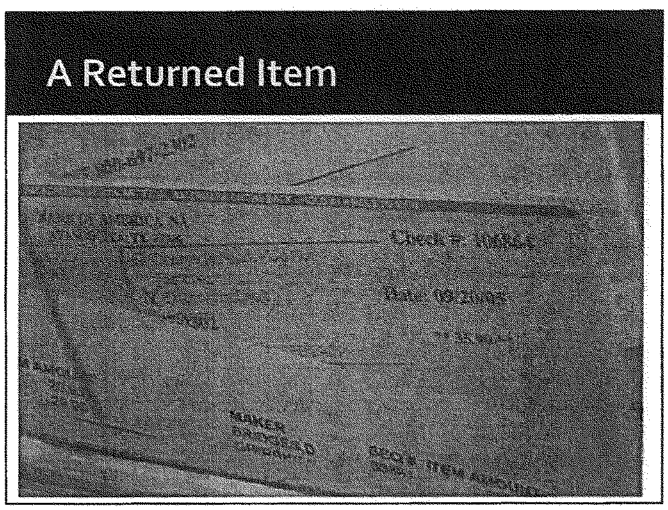
Return Reasons

- More than 50 percent of PPC's returns facially identified as:
  - UNAUTHORIZED
  - FRAUD
  - REFER TO MAKER
- Every month Wachovia received and hand-processed thousands of **sworn affidavits from consumers alleging that PPC debit transactions were not authorized**

26

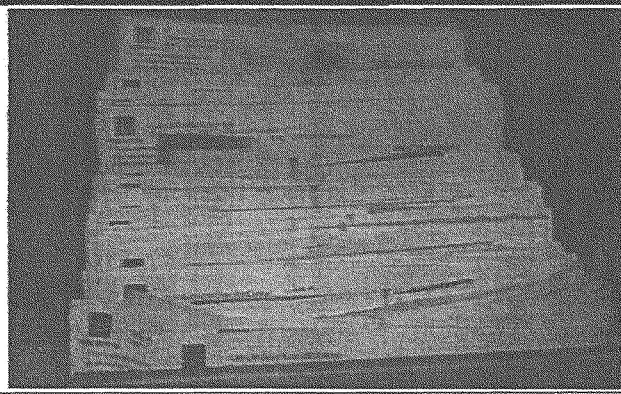


Check appropriate Section I OR Section II:
I. Draft Never Authorized:
I have never authorized the company named above to debit my account
5-17-05

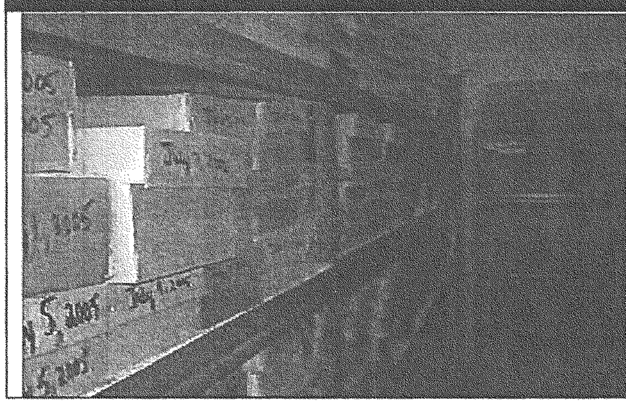


A Returned Item
BANK OF AMERICA, NA
Date: 09/20/05
MAKER

A Box of Returned Items



A Room of Boxes of Returned Items

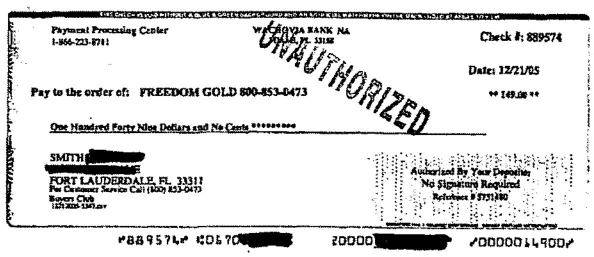


Outlier Business Practices

- PPC regularly transferred large amounts of money to overseas accounts.
- Wachovia allowed PPC to deposit RCCs payable to third-party merchants into its own accounts – without agency agreements.
- The Wachovia/PPC business model was based on large volumes of returns – an ordinarily suspect and undesired result.
- Wachovia's own customers often treated differently than other banks' customers.

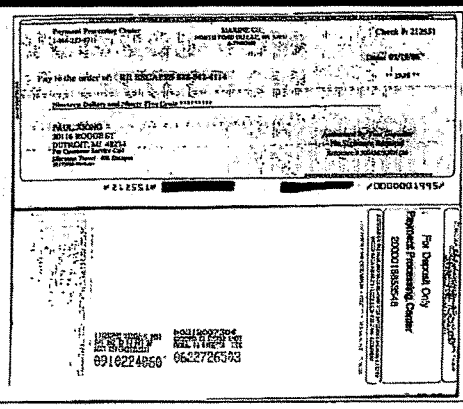
31

"On the House" Returns


Payment Processing Center
1-866-223-8741
WACHOVIA BANK NA
Check #: 889574
Date: 12/21/05
UNAUTHORIZED
Pay to the order of: FREEDOM GOLD 800-853-0473
** 149.00 **
One Hundred Forty Nine Dollars and No Cents *********
SMITH [redacted]
FORT LAUDERDALE, FL 33311
For Customer Service Call (800) 853-0473
Buyers Club
Authorized By Your Depositor
No Signature Required
⑈889574⑈ ⑆0670 [redacted] 20000 [redacted] ⑈0000014900⑈

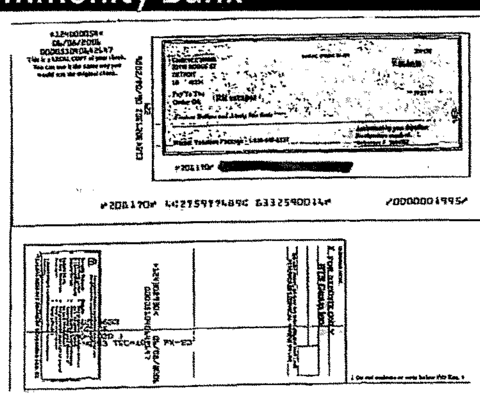
32

"Whack-a-Mole"



33

Migration from National Bank to Community Bank



34

Wachovia Ignored Internal Concerns

Return "volumes are tremendous" and "payment of these items is not our normal process"

Returns Operations Supervisor to VP of Loss Management

"Nothing [PPC] could ever do would make me comfortable . . ."

Bank Loss Management Official after learning about Bank relationship with PPC

After Loss Management official recommended closing PPC accounts, wrote "business line has assumed risk for the customer and decided to keep their accounts open"

Communication between Bank Loss Management Officials

35

Wachovia Ignored Internal Concerns

"Please consider the regulatory and reputational risks involved here. **We have now been put on notice that accounts at [Bank] are being used . . . to further these schemes.**

"If PPC has in place 'a standing agreement with [Bank] to pay all claims without dispute,' then they know they have rogue telemarketers in their customer base."

Internal E-mail from Bank's In-house Counsel after receiving fraud warning from another bank

36

DOUBLE YIKES!!!!

To
cc
08/23/2005 06:35 PM
Subject Guardian Marketing # 2000027007068

Tom,
Bob, Tim & I need to huddle with you on this account relationship. It is a Business Banking account. It has been actively making deposits since 6/23/05 and there is a current balance of $743,000+ in the account. The account came to us from B of A (so we are advised by in Bus. Bnkg.) and she is

ALL their deposits are THIRD PARTY DRAFTS!!! DOUBLE YIKES!!!!

YIKES!!!! Moreover, the drafts that are being deposited and are charging back, are not $99.99; these items are all over the place in terms of their amount. Moreover, there is another account, Suntasia, #2000027027721. Same address, same principals. $ from the Guardian acct is transferred to Suntasia and then the $ is wired out to Bank of America (funny, I thought I said they were leaving B of A at the

And, there is more, but nothing more that I want to put into a note. Bob and I really need to talk o you on tomorrow,

Thanks,

37

Wachovia Ignored Explicit Fraud Warnings From Other Banks

"The purpose of this message is to put your bank on notice of this situation and to ask for your assistance in trying to shut down this scam . . . instigate an investigation into whether [PPC is] conducting legitimate business and whether [Bank is] getting a high volume of return items on those accounts (that should place your bank on notice of potential fraud)."

E-Mail from Citizens Bank

38

Bank's "Oral Agreement" With PPC To Pay All Returns

- Intended to protect Bank's reputation rather than consumers

"[I]f we can find a way to pay the returns . . . without sending them back to other banks, I think that will go a long way to preserve our reputation. **The sooner the complaint gets paid the quicker it goes away.**"

Internal Bank e-mail

- Demonstrates that UCC warranty rule is not an effective anti-fraud tool

39

Money Motivates

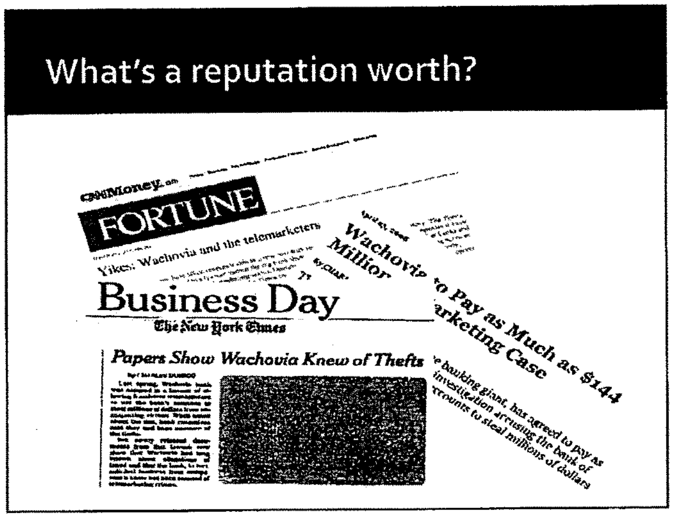
"[P]lease mark your calendar – we will take them somewhere nice for lunch. We are making a ton of money from them."

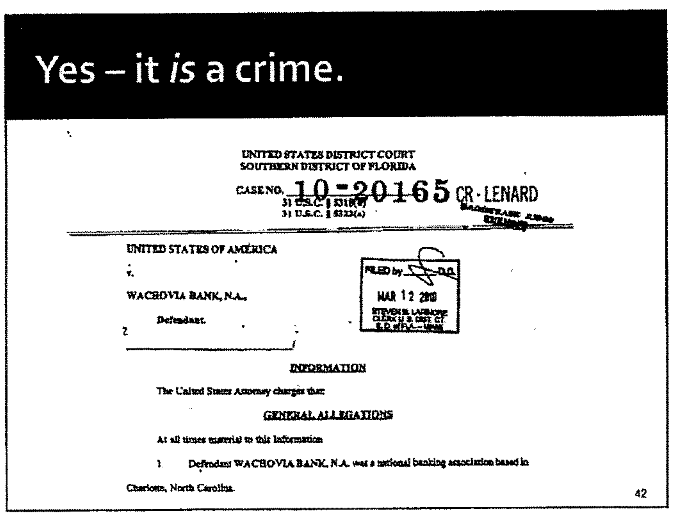
Bank Relationship Manager to Senior Business Development Officer

"[T]his is our most profitable account. $1mm per year in profit. They have asked for Eagle tickets. What can we do?? They deserve them with all we make from them."

Bank Relationship Manager to Senior Business Development Officer

40


What's a reputation worth?
CNNMoney.com
FORTUNE
Yikes: Wachovia and the telemarketers
Business Day
The New York Times
Papers Show Wachovia Knew of Thefts
Wachovia to Pay as Much as $144
Millior
arketing Case
banking giant, has agreed to pay as
investigation accusing the bank of
ccounts to steal millions of dollars


Yes – it *is* a crime.
UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
CASE NO. 10-20165 CR-LENARD
31 U.S.C. § 5318(h)
31 U.S.C. § 5322(a)
UNITED STATES OF AMERICA
v.
WACHOVIA BANK, N.A.,
Defendant.
FILED by D.C.
MAR 12 2010
STEVEN M. LARIMORE
CLERK U.S. DIST. CT.
S.D. of FLA. - MIAMI
INFORMATION
The United States Attorney charges that:
GENERAL ALLEGATIONS
At all times material to this Information:
1. Defendant WACHOVIA BANK, N.A. was a national banking association based in Charlotte, North Carolina.
42

It's not over until it's over.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

UNITED STATES OF AMERICA	CRIMINAL NO. 11-
	DATE FILED: February 18, 2011
v.	VIOLATIONS:
DONALD HELLINGER RONALD HELLINGER MICHAEL WEISBERG RANDY TROST JAMI PEARLMAN MICHELE QUIGLEY	18 U.S.C. § 371 (conspiracy – 1 count) 18 U.S.C. § 1960 (operating an illegal money transmission business – 1 count) 18 U.S.C. § 1955 (operating an illegal gambling business – 1 count) 18 U.S.C. § 1084 (transmission of wagers and wagering information – 8 counts) 18 U.S.C. § 1956(a)(2)(A) (international money laundering – 3 counts) Notice of forfeiture

INDICTMENT

COUNT ONE

THE GRAND JURY CHARGES THAT:

At all times relevant to this indictment:

BACKGROUND

1. Defendants DONALD HELLINGER, RONALD HELLINGER, MICHAEL WEISBERG, RANDY TROST, JAMI PEARLMAN and MICHELE QUIGLEY

43

Financial accountability -- thanks to federal agents, prosecutors, and bank regulators, class action attorneys, local and state law enforcement, *The New York Times*, and many determined victims of consumer fraud !

44

A simple proposition.

Mass-market scammers need access to payment systems (RCC's, ACH, CC) to take consumers' money. Without bank access there are no unauthorized withdrawals.

Banks are stationary (no "whack-a-mole"), regulated, and are concerned about reputational risk.

Banks already are required to have systems in place to prevent criminals from accessing the banking system.

Cutting off the scammers' access to the payment systems is relatively efficient and fast, and protects consumers prospectively as we investigate.

45

Important steps forward . . .

- Guidance to banks from FDIC, OCC and FinCEN
- United States v. First Bank of Delaware
- Financial Fraud Enforcement Task Force/Consumer Protection Branch efforts to choke-off fraudsters' access to payment systems (DOJ, FTC, FDIC-OIG, USPIS, FBI, and others)
- May 21, 2013: FTC Notice of Proposed Rulemaking would ban the use of RCCs in connection with telemarketing

46

Operation Choke Point
So far . . .

- More than 50 subpoenas issued to banks and TPPPs.
- Several active criminal and civil investigations.
- Banks are self-disclosing problematic TPPP relationships.
- Banks are terminating TPPP relationships and scrutinizing scammer relationships.
- Internet Payday lending – collateral benefits.
- Investigative support from USPIS, FBI, SIGTARP, USSS

47

Regulatory Loophole

- Treasury Department regulation amended in 2011 arguably excludes third-party payment processors from the definition of "money transmitter" and thus is not a Money Services Business ("MSB").
- **A payment processor that originates tens of millions of dollars of debit transactions against consumers' bank accounts on behalf of Internet and telemarketing merchants may not be an MSB and may not be required to register with FinCEN or comply with the BSA.**

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Thanks for your time and interest!

Questions?

Joel M. Sweet
202-532-4663
joel.sweet@usdoj.gov

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AMERICAN BANKER.

DOJ's 'Operation Choke Point': An Attack on Market Economy

William M. Isaac
MAR 21, 2014 10:00am ET

History teaches that when government bureaucracies try to direct economies, stifled creativity, distorted markets and low economic growth are inevitable results. One of the easiest and most insidious ways for bureaucrats to control the U.S. economy is through the banks, directing who gets – and who can't get – loans and other essential banking services. That's happening today, and it ought to alarm and frighten all of us.

I opposed enactment of the Troubled Asset Relief Program bailout legislation during the crisis of 2008 because I believed the legislation would not work, would exacerbate the crisis in confidence, and would create a political backlash that would damage the financial industry and economy for years to come.

Tarp did not resolve, and, in fact, fed the crisis. Moreover, the unnecessary and unwise use of taxpayer money to fund Tarp led to the worst political and regulatory nightmare for the financial industry in modern history – and it's far from over.

Apparently, the government now believes that it is open season on banks. A particularly egregious example of abuse of power involves the Department of Justice, apparently in alliance with at least some

federal bank regulators. The DOJ, without color of law, is engaged in a crackdown called "Operation Choke Point" to drive short-term, unsecured lending (commonly called payday lending) out of the banking system.

Some consider payday lending predatory and urge that it be banished. They argue the interest rate is exorbitant, leading some borrowers to become "hooked" on a cycle of debt. Others, including myself, believe short-term lending is needed by tens of millions of people, and it is better to allow regulated financial firms to offer the product than forcing consumers into worse and more dangerous avenues to meet emergency financial needs. What we need is more competition to improve pricing and other terms.

This debate has been going on in Congress and state legislatures for many years. Most states allow short-term lending subject to various regulations. Congress has thus far deferred to the states.

The DOJ and some bank regulators are attempting to force banks out of the short-term lending business, including providing check clearing and other banking services to firms that offer payday loans and check-cashing services. It matters not that these services are lawful. It matters not that Congress and state legislatures have had many opportunities to shut down short-term lending and most have elected not to do it.

Put aside your views of payday lending, as they are not relevant to the issue I am raising in this article. If government bureaucrats, acting without statutory authority, can coerce banks into denying services to firms engaged in lawful behavior that the government does not like, where does it stop? The same slippery slope that the DOJ uses today to choke off payday lenders from banking services could tomorrow be used on convenience stores selling large sugary sodas, restaurants offering foods with high trans-fat content or family planning clinics performing abortions.

Ironically, at the same time, government is making life miserable for businesses seeking to meet consumer needs for emergency funds it is encouraging banks to offer services to marijuana dealers. While marijuana sales are authorized in a few states, it remains a felony in most states and under federal law.

Many people get "hooked" spending a lot of money on marijuana. The same is true with gambling, alcohol and cigarettes. Notable differences between these businesses and payday lending are: 1) payday lending is *providing* funds to people in need, 2) payday lending is not ingested and does not cause bodily harm and 3) government does not derive vast amounts of revenue from payday lending.

The point is simple and incredibly important. Under our constitutional republic and market-based economic system, unelected bureaucrats should not decide which lawful businesses may have access to banking services and which are to be denied. People who have serious concerns about payday lending or check-cashing services should take their concerns to state or federal legislatures and attempt to enact reforms.

The DOJ should not be involved in bank regulation to any extent whatsoever. Its job is to investigate and prosecute crimes. Bank regulators need to stay out of the political arena and focus all of their energy on ensuring banks are operating in a safe and sound manner and are complying with all laws and regulations. Neither the DOJ nor bank regulators should be allowed to dictate which lawful

businesses will be granted or denied access to banking services.

William M. Isaac, former chairman of the Federal Deposit Insurance Corp., is global head of Financial Institutions for FTI Consulting and author of "Senseless Panic: How Washington Failed America." The views expressed are his own.

National Credit Union Administration
Office of General Counsel

April 9, 2014

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Committee
B-301C Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

At yesterday's hearing entitled "Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom," Congressman Brad Sherman asked a question about supplemental capital in relation to NCUA's proposed rule on risk-based capital. I write to provide greater clarity about my response to this thoughtful question.

NCUA currently has very limited statutory authority to establish supplemental capital that would benefit federally insured, consumer credit unions by enhancing their "net worth" for prompt corrective action purposes. Except for those credit unions designated as low-income, Congress limited the definition of "net worth" in the Federal Credit Union Act to retained earnings as defined by generally accepted accounting principles.[1] Therefore, unless Congress amends the statutory definition of "net worth," other forms of capital, including supplemental capital, cannot legally be counted as "net worth" for federally insured, consumer credit unions, other than those with a low-income designation.

NCUA did specifically address the issue of supplemental capital for low-income designated credit unions in the proposed rule on risk-based capital. NCUA would allow low-income credit unions to count supplemental capital, or "secondary capital" as it is referred to in the proposed rule, in the risk-based capital numerator for purposes of calculating their risk-based capital ratio. In other words, under the proposed rule, consumer credit unions that are authorized to issue supplemental capital under the Federal Credit Union Act would be allowed to enhance their risk-based capital ratios for prompt corrective action purposes.

A consumer credit union's inability to raise capital outside of retained earnings limits its ability to serve its members. NCUA has therefore previously encouraged Congress to consider authorizing healthy, well-managed consumer credit unions, as determined by the NCUA Board, to issue supplemental capital that will count as net worth.

The House Financial Services Committee currently has under consideration H.R. 719, the Capital Access for Small Businesses and Jobs Act. NCUA supports this legislation. This bill would provide consumer credit unions with an additional tool to promote sufficient capital stability—even under adverse economic conditions—and ensure that healthy, well-managed

[1] 12 U.S.C. §1790d(o)(2)

Chairman Hensarling and Ranking Member Waters
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consumer credit unions would no longer be forced to turn away deposits in order to protect their net worth ratios.

In closing, NCUA welcomes comments on all aspects of the proposed rule on risk-based capital. Interested parties have until May 28, 2014, to comment on the proposal. NCUA also stands ready to work with the House Financial Services Committee on H.R. 719 or similar proposals to increase access to supplemental capital for healthy, well-managed consumer credit unions.

Sincerely,

Michael J. McKenna
General Counsel

cc: The Honorable Brad Sherman
Member of Congress
2242 Rayburn House Office Building
Washington, DC 20515

<u>**Questions for Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative Garrett:**</u>

1a. Mr. Alvarez stated that the agencies do not have authority under the Volcker Rule statute to grant CLOs the workable relief that affected entities claim they need. Mr. Alvarez said that the statute does not contain a provision that allows grandfathering and also does not allow the agencies to issue an exemption merely because the banking entities may face losses.

Please explain why the authority claimed by the agencies in their interim final rule on the treatment of TruPS CDOs (i.e., authority "under section 13 of the Bank Holding Company Act" (the Volcker Rule statute)) does not apply here. First, the interim final rule essentially grandfathers certain TruPS CDOs. Second, the interim final rule is based on a belief by the agencies that, absent relief, some banking entities would be required to dispose of their holdings of TruPS CDOs, "which, [the banking entities] contend, could have an immediate effect on their financial statements and their bank regulatory capital." That is, the interim final rule was issued to prevent losses to these banking entities. Third, the interim final rule makes no finding about safety and soundness. Please address why each of these points is not equally applicable in the case of CLOs.

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which added a new section 13 to the Bank Holding Company Act of 1956 (BHC Act), generally prohibits banking entities from engaging in proprietary trading and from acquiring or retaining an ownership interest in, or acting as sponsor to, a hedge fund or private equity fund (each a covered fund). After approval of the final rule implementing section 13 of the BHC Act (Final Rule) on December 10, 2013, a number of community banks and trade groups expressed concern about the potential adverse financial impact that the accounting rules would impose on investments covered by section 13 in collateralized debt obligations backed by trust preferred securities (TruPS CDOs). Further, many community banking organizations and industry advocates raised concerns that the Final Rule conflicted with the Congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather certain instruments issued by community banking organizations, including trust preferred securities. To your point on requiring some banking entities to dispose of their holdings of TruPS CDOs, a number of community banks argued that there was an urgent need to act in light of the uncertainty about whether the Final Rule would require them to dispose of their holdings of TruPS CDOs, which community banking organizations contended could have resulted in an immediate effect on their financial statements and their bank regulatory capital due to accounting rules.

After carefully reviewing this matter, the Office of the Comptroller of the Currency, the Federal Reserve, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and the Commodity Futures Trading Commission (the Agencies) issued an interim final rule (Interim Final Rule) on January 14, 2014, that permits banking entities (regardless of size) to retain their existing interests in securitization vehicles primarily backed by trust preferred securities or subordinated debt instruments defined by reference to the standards in section 171(b)(4)(C) of the Dodd-Frank Act. While section 13 of the Dodd-Frank Act does not contain a provision grandfathering existing investments in covered funds, the Agencies took this action for TruPS CDOs to reconcile section 13 of the BHC Act with section 171 of the Dodd-Frank Act, which

provides for the permanent grandfathering of debt and equity securities issued before May 19, 2010, by any depository institution holding company that had total consolidated assets of less than $15 billion as of December 31, 2009, or was a mutual holding company on May 19, 2010. As explained in the Interim Final Rule, in order to avoid imposing restrictions that could adversely affect the TruPS CDOs market in a manner that could undercut the grandfathering provisions that Congress provided in section 171 of the Dodd-Frank Act, the Agencies found that certain TruPS CDOs should be permitted for all banking entities under section 13.

Ownership of collateralized loan obligations (CLOs) may also be covered by section 13 of the BHC Act under certain circumstances. The statute contains a rule of construction that excludes securitizations of loans. In keeping with this statutory provision, the Final Rule excludes from the definition of covered fund any securitization vehicle that is comprised solely of loans and related servicing assets, including CLOs backed entirely by loans. Some CLOs are backed by a combination of loans and other, non-loan assets, such as securities. As noted above, section 13 covers investments in these types of CLOs and does not contain a grandfather provision for these investments. Also, unlike the case involving TruPS CDOs, there is no conflict between this statutory prohibition and any other provision of the Dodd-Frank Act. Accordingly, the Agencies believed Congress intended that these investments be conformed to the prohibitions in section 13 of the BHC Act.

To address investments in CLOs that are backed in part by non-loan assets, the Federal Reserve issued a statement in April 2014, indicating that it intends to grant two additional one-year extensions of the conformance period that would allow banking entities additional time to conform these ownership interests and sponsorship activities to the statute and implementing rules. All of the agencies charged with implementing section 13 support the Federal Reserve's statement.

Data reported to the federal banking agencies by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9-C forms indicate that only about 50 domestic banking organizations held CLOs, both conforming and non-conforming, as of December 31, 2013. The data also indicate that aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income.

Additionally, based on discussions with industry representatives and a review of data provided by market participants, new issuances of CLOs in late 2013 and early 2014, appear to be conforming to the Final Rule, and some CLOs issued before December 31, 2013, are conforming their investments to the provisions of section 13. It appears, based on public data sources, that the current volume of new CLO issuances is higher than the volume of CLOs issued prior to the adoption of the Final Rule. U.S. CLO issuances have increased to a post-crisis high of approximately $13.8 billion in June 2014, which is the most ever issued in a single month. Total quarterly issuance of CLOS for the second quarter of 2014, was $37.9 billion, making it the largest single quarter for U.S. CLO issuance on record.

To the extent that the Final Rule has unintended impacts, the Agencies would evaluate and address those impacts within the parameters of the statute if that is possible, and otherwise inform Congress.

1b. Please explain why the agencies could not use their general rulemaking authority under section 13(b)(2), which is what they appear to have done in the case of the interim final rule.

Please see response to 1a.

2. In response to a request from Congressman Stivers about the authority to grandfather CLOs, Mr. Alvarez replied *that "... we would have appreciated the flexibility to be different, but the statute is quite specific. It says that we can grant three one-year extensions, but no more than one at a time."* That answer, however, goes to the Federal Reserve's authority to extend the conformance period and not to its general rulemaking authority under the Volcker Rule statute. Why does section 13(b)(2) of the statute, which requires the agencies to "*adopt rules to carry out this section*" not provide the agencies with the authority to grandfather legacy CLOs?

As you note, the authority contained in section 13(b)(2) requires the Agencies to adopt rules to carry out the prohibitions, including exemptions to those prohibitions, contained in section 13. Section 13 generally prohibits a banking entity from acquiring or retaining an interest in a covered fund, which includes a CLO. Section 13(c)(2) of the BHC Act is specific about the timeframe within which each banking entity must "bring its activities and investments into compliance" with the requirements of section 13. The Agencies do not believe that the general rulemaking authority under section 13(b)(2) enables them to issue rules that are contrary to the explicit provision in section 13(c)(2).

3. In adopting the Final Rule, the agencies used their rulemaking authority under section 13(b)(2) (and not their safety and soundness exemptive authority under section 13(d)(1)(J)) to carve out a number of investment structures from the covered fund definition, such as wholly-owned subsidiaries, acquisition vehicles, and joint ventures. While we applaud the agencies' recognition that the Volcker Rule was not intended to capture them, we do not understand why the agencies could not use the same rulemaking authority to carve out legacy CLOs.

As explained in the preamble to the Final Rule, one of the purposes of section 13 appears to be to limit the involvement of banking entities in investments in, sponsorship of, and other connections with hedge funds and private equity funds.

The Final Rule excludes a number of entities from the definition of covered fund that are not hedge funds, private equity funds or other similar investment vehicles. Rather, excluded entities generally serve as operating entities that conduct business operations. CLOs, on the other hand, are investment vehicles designed to raise funds from investors for the purpose of sharing in the income, profits and losses from investments in the same way as a hedge fund or private equity fund.

4. Are the agencies taking the position that the statute's rulemaking authority does not permit them to amend the Final Rule if it no longer makes sense, e.g., because of changes circumstances or new data or even if the agencies change their minds about how best to implement the statute? Are the agencies saying that their hands are completely tied? If so, please point to authority that establishes that proposition?

To the extent that the Final Rule has unintended impacts, the Agencies would seek to evaluate and address those impacts within the parameters of the statute if that is possible, and to otherwise inform Congress.

5. Mr. Alvarez testified that *"[T]he proposed rule had something on the order of a dozen questions about asset-back securitizations, including CDOs. It asked about how the ownership interest should be defined? How the instrument should be treated under the Volcker Rule."* But the Proposed Rule was very clear that it intended to consider the concept of ownership interest holistically and nowhere suggested that a right to replace a manager for cause, without more, would by itself be considered an ownership interest. Because of this, the banks that hold CLO debt securities had no basis for thinking that this limited voting right by itself would end up constituting an ownership interest. The banks have now provided myriad data to show the agencies the scope of the issue. Why do the agencies feel that they are unable to respond adequately to this new data? Would they acknowledge that there is a fairness element here, and that there may not have been adequate notice that the agencies would go down this road?

Subsequent to approval of the Final Rule, some commenters have requested that the Agencies modify the definition of "ownership interest" to exclude debt securities that have the ability to participate in the selection or removal of the collateral manager or similar party to a CLO. This approach to the definition of ownership interest would affect all types of covered funds, not just interests in CLOs. Consequently, staffs of the Agencies continue to review this suggestion and the implications this approach would have for investments in covered funds generally, including nonconforming CLOs and other types of covered funds.

6. When Congress decided to exclude loan securitizations from the Volcker Rule statute, we intended to allow the CLO markets to continue largely as they were at the time we enacted the statute. At that time, 100 percent of existing CLOs held some percentage of debt securities. None of them were made up only of loans. Why did the Final Rule not provide relief for CLOs as we all understood them to exist at that time? And even if, going forward, we understand that new CLOs can be structured to be loan-only, why would the agencies not find a way to provide workable relief for CLOs that existed at the time of our instruction not to mess with that market?

Section 13 of the BHC Act prohibits many investments that were legally permissible before its enactment. As noted above, the statute also contains a rule of construction that excludes securitizations of loans. The Agencies have tried to apply the statute to investments in CLOs within the constraints of the statute.

7. I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations or statutory language that restrict FSOC voting members (the Agencies' principals), from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NPD) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD. Do the Agencies support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on a NPD.

Section 113 of the Dodd-Frank Act establishes the process for Financial Stability Oversight Committee (FSOC) to designate a nonbank financial company for supervision by the Federal Reserve Board. This statutory process includes providing the opportunity for a company to request a hearing, including an oral hearing, before the FSOC. To date, only one company has requested an oral hearing. The FSOC granted that request--representatives of the company presented its arguments directly to the FSOC members themselves.

Building on the process set out in the statute, the FSOC published a rule governing how it will proceed in considering nonbank financial companies for a proposed and final designation. This rule, which was published for comment three times, provides a company additional due process not contained in the statute prior to a notice of proposed designation. In particular, the rules provide that the FSOC will provide notice to a company that it is being considered for designation and the company is provided the opportunity to submit in writing any arguments or information it believes relevant prior to a proposed designation.

In addition, prior to developing a recommendation regarding a proposed designation, the staffs of the FSOC and its members engage in extensive dialogue with the company both through written questions and in face to face meetings. FSOC has not limited the amount or types of information a company may submit either to support its arguments as to why it should not be designated or in response to information requests. As such, a company has considerable opportunity to present its views, including the opportunity to meet directly with FSOC members as well as staff, before FSOC makes a designation.

8. During your testimony, you stated that you would work with my office regarding the release of the final 2003-2008 Operations Report of the Federal Reserve Banks. Given the Fed's expansive supervisory and prudential oversight functions, the release of these reports will facilitate appropriate Federal Reserve transparency and accountability. Will you provide the committee these reports for 2003-2008 period?

Under the Federal Reserve Act, the Federal Reserve Board exercises general supervision of the Federal Reserve Banks and, in that capacity, the Board regularly conducts reviews of various Reserve Bank functions. You asked specifically about the operations reviews conducted by the

Board's Divisions of Banking Supervision and Regulation and Consumer and Community Affairs of the supervision departments of each Reserve Bank. These reviews are typically scheduled on a three-year cycle. In the operations reviews, the Board reviews the effectiveness of each Reserve Bank's supervision function, including functions delegated by the Board to the Reserve Bank. The reports are written for internal Federal Reserve use and contain confidential supervisory information relating to the Reserve Banks' supervision of financial institutions, compliance with Board guidance, and the effectiveness of Reserve Bank management oversight. These reports often include information related to the specific financial institutions, which is non-public confidential supervisory information protected by statute. In addition, the reports may contain confidential personnel information. For these reasons, the Board will not be able to provide copies of the requested operations reviews.

9. There have been several recent reports expressing concern about the Federal Reserve refusing to publicly disclose the salaries of its employees. One of these reports also found that the Fed's banking regulatory counterparts were being paid exponentially more than other federal government employees on the GS-Scale of similar experience and time of service. Given the federal government's current debt of over $17 trillion and ongoing annual budget deficits in the hundreds of billions, it is critically important that Congress is able to conduct its critical oversight function on how all taxpayer dollars are being allocated. Will you agree to please provide either public reports of all of the individual employees of the Federal Reserve (similar to the U.S. Congress) or to the Committee?

The Board publicly discloses the amount spent on salaries of Board employees in its Annual Report. The Board's audited financial statements, reproduced in the Annual Report, include a line item that lists the amount of money the Board spends on salaries. You may find the Annual Report on the Board's public website at the following link: http://www.federalreserve.gov/publications/annual-report/2012-contents.htm

The Board has also published its salary structure, for non-officer employees, on its public website. That information can be found at the following link: http://www.federalreserve.gov/careers/salary.htm. The Board also discloses, upon request, the salary structure for its officer employees. Enclosed is a copy of that salary structure for your information.

Finally, the Board has also received requests for information about its top earners, which are defined as individuals who are paid a salary of $225,000 or more. In response to such requests the Board has provided the name, title, and division of each employee who earns $225,000 or above. A copy of this list is also enclosed for your information.

<u>Questions for The Honorable Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative King:</u>

1. I am glad that representatives from the FDIC, OCC and the Fed are all here today, because I would like you all to comment on the Liquidity Coverage Ratio proposal your agencies put out to comply with the Basel Committee's requirements. I am particularly concerned about how the treatment of municipal securities and deposits will affect municipalities – including New York City and communities affected by Superstorm Sandy – which depend heavily on muni bonds to fund critical infrastructure. Can you explain why your agencies did not grant municipal bonds status as "High Quality Liquid Assets" (HQLA), despite the Basel Committee's recommendation to do so? I understand that under your proposal corporate bonds and even sovereign debt were given HQLA treatment. Why is the debt of small nations whose sovereign securities are illiquid or even distressed, are treated as higher quality than securities from our own states and districts? Can you explain that decision?

The goal of the liquidity coverage ratio (LCR) is to ensure that covered companies are able to meet their short-term liquidity needs during times of stress. The inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. To ensure adequate liquidity, the final rule includes as high-quality liquid assets (HQLA) only securities that historically have been readily convertible into cash with little or no loss of value during a period of stress, either by sale or through a repurchase transaction. The OCC, FDIC, and Board considered various types of assets for treatment as HQLA and evaluated relevant market data relating to the liquidity characteristics.

Under the LCR final rule issued on September 3, 2014, securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) do not qualify as HQLA. However, the Board has reviewed market data regarding municipal securities and the information provided by commenters and is exploring the development of a new proposal for public comment to treat as HQLA for purposes of the LCR requirement municipal securities that trade readily and have liquidity characteristics that are comparable to other HQLA assets.

2. Your agencies' LCR proposal also treats municipal deposits as secured transactions under the rule which means they would be subject to a 100% unwind for purposes of the ratio calculation. I am concerned this will hamper municipalities' ability to seek the banking services they need to make pay-roll and fund day-to-day activities. Can you comment on why these deposits were treated as secured transactions under the proposal?

Under the LCR notice of proposed rulemaking (NPR), collateralized municipal deposits would have been treated as secured funding transactions to permit the deposits to be eligible for lower outflow rate to the extent the deposits are secured by high-quality collateral. To the extent that a municipal deposit is not secured, the deposit would not be treated as a secured funding transaction. The NPR also had another feature that would have provided for a mathematical unwind of all secured funding transactions to ensure that firms did not enter into secured transactions for the purpose of manipulating their level of HQLA to avoid the liquid asset cap limitations.

The OCC, FDIC, and the Board recently finalized the LCR on September 3, 2014. In response to comments regarding the application of the unwind requirement for secured funding transactions to municipal and certain other types of secured deposits, the agencies determined in the LCR final rule not to require the unwind of secured municipal deposits.

Questions for Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative Maloney:

1. In the letter that I, and 16 other Democrats, sent to the regulators on February 12, 2014, we stated that the right to vote on removing an investment manager in traditional, creditor-protective circumstances such as a material breach of contract should not, by itself, trigger an "ownership interest" under the Volcker Rule.

The industry has requested clarification on the scope of the voting rights prong of the "ownership interest" definition in several letters to the regulators as well.

Despite the considerable time that the regulators devoted to the CLO issue, neither the Fed's statement nor the regulators' joint letter to Chairman Hensarling mentioned this voting rights issue.

Do the agencies plan to clarify whether such traditional, creditor-protective voting rights would automatically trigger an "ownership interest" under the Volcker Rule? If so, when do the regulators plan on issuing this clarification?

On April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period under section 13 of the Bank Holding Company Act (BHC Act) that would allow banking entities additional time to conform to the statute, ownership interests in and sponsorship of collateralized loan obligations (CLOs) in place as of December 31, 2013, that do not qualify for the exclusion in the final rule implementing section 13 of the BHC Act (Final Rule) for loan securitizations.[1] This would permit banking entities to retain until July 21, 2017, ownership interests in and sponsorship of CLOs that were not backed entirely by loans that were held as of December 31, 2013.

Commenters, including members of Congress and industry participants, have also requested that Office of Comptroller of the Currency, the Federal Reserve, Federal Deposit Insurance Company, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the Agencies) modify the definition of "ownership interest" to exclude debt securities that have the ability to participate in the selection or removal of the collateral manager or similar party to a CLO. This approach to the definition of ownership interest would affect all types of covered funds, not just interests in CLOs. Consequently, staffs of the Agencies continue to review this suggestion and the implications this approach would have for investments in covered funds generally, including nonconforming CLOs and other types of covered funds.

2. In the regulators' joint letter on CLOs April 7, 2014, the regulators provided limited relief by giving banks 2 additional years to divest of their legacy CLOs — but they also said that banks were still undertaking a review of their CLO holdings.

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[1] See Board Statement Regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act (Apr. 7, 2014).

Once the banks are finished with this review of their CLO holdings, would the regulators consider providing further relief based on the results of these reviews?

As noted in the letter of April 7, 2014, data reported to the federal banking agencies by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9-C forms indicate that, as of December 31, 2013, only about 50 domestic banking organizations held CLOs, including both CLOs that conform to the exclusion in the implementing rules of the Agencies, and CLOs that do not conform to that exclusion. The data also indicate that aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Additionally, based on discussions with industry representatives and a review of data provided by market participants, new issuances of CLOs in late 2013 and early 2014, appear to be conforming to the Final Rule and some CLOs issued before December 31, 2013, appear to be conforming their investments to the provisions of section 13. It appears, based on public data sources, that the current volume of new CLO issuances is higher than the volume of CLOs issued prior to the adoption of the Final Rule. U.S. CLO issuances have increased to a post-crisis high of approximately $13.8 billion in June 2014, which is the most ever issued in a single month. Total quarterly issuance of CLOs for the second quarter of 2014, was $37.9 billion, making it the largest single quarter for U.S. CLO issuance on record.

As banks continue to review their CLO holdings and provide the regulators with updated information, to the extent that the Final Rule has unintended impacts, the Agencies would seek to evaluate and address those impacts within the parameters of the statute if that is possible, and otherwise to inform Congress.

3. Is the statement that the Fed released on April 7, 2014 on CLOs the consensus of the inter-agency working group that the regulators set up to deal with Volcker Rule issues? Did all of the agencies formally vote on approving the Fed's statement on CLOs? And if not, why not?

By statute, only the Federal Reserve has authority to extend the conformance period for section 13 of the BHC Act.[2] Specifically, section 13(c)(2) of the BHC Act provides that a banking entity must conform its activities and investments to the prohibitions and restrictions of that section and any final implementing regulation no later than 2 years after the statutory effective date of section 13, which is July 21, 2012, unless extended by the Federal Reserve. Under the statute, the Federal Reserve may, by rule or order, extend the two-year conformance period not more than one year at a time, for a total of not more than 3 years, if in the judgment of the Federal Reserve, an extension is consistent with the purposes of section 13 and would not be detrimental to the public interest.

Pursuant to this statutory authority, on April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional one-year extensions of the conformance period under section 13

[2] See 12 U.S.C. 1851(c)(2).

of the BHC Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule implementing section 13 of the BHC Act for loan securitizations. This would permit banking entities to retain until July 21, 2017, ownership interests in and sponsorship of CLOs that were not backed entirely by loans that were held as of December 31, 2013.

Before taking this action, the Federal Reserve consulted with each of the Agencies responsible for implementing and enforcing section 13 of the BHC Act. Those Agencies supported the Federal Reserve's proposed extension of time and indicated they would enforce section 13 and the final rule in accordance with the Board's conformance rule, including any extension of the conformance period applicable to CLOs.[3]

[3] See Letter to Chairman Hensarling re: CLOs (Apr. 7, 2014).

Questions for Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System from Representative Moore:

1. On September 28, 2014, I was one of several Democrats that wrote Chairman Gruenberg to gain clarification regarding FDIC handling of bank examinations that do business with third-party processors and online non-bank lenders. I would appreciate further explanation of what your agencies are doing to coordinate with the Consumer Financial Protection Bureau to ensure a consistent regulatory regime of these products, given that the CFPB was given jurisdiction for these products under Dodd-Frank. I absolutely support the elimination of bad actors and unscrupulous practices that threaten the safety and soundness of banks, but I continue to believe that it is important for your agencies to work with the CFPB as not to preempt their jurisdiction over these products and to permit them to be lawfully offered consistent with CFPB regulations.

You have asked how the Federal Reserve coordinates with the Consumer Financial Protection Bureau (CFPB) to ensure consistent regulation of products offered by third-party processors and online non-bank lenders. We coordinate closely with the CFPB in a number of ways.

The Federal Reserve is responsible for ensuring that the financial institutions it supervises comply with applicable federal consumer financial laws. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transferred to the CFPB supervisory authority for insured depository institutions[1] with total assets in excess of $10 billion and their affiliates for compliance with eighteen enumerated consumer laws and their implementing regulations. Supervisory authority over these institutions for other federal consumer financial services statutes and regulations, including prohibitions on unfair and deceptive acts or practices under Section 5 of the Federal Trade Commission Act, was retained by the Federal Reserve. The Federal Reserve also retained supervisory authority for all federal consumer financial laws and regulations for financial institutions with total assets of $10 billion or less. Further, the Dodd-Frank Act generally transferred rulewriting authority under the enumerated consumer laws to the CFPB. The Board consults with the CFPB on its rulemaking activities under Section 1022(b) of the Dodd-Frank Act, which requires the CFPB to consult with the appropriate federal agencies before proposing rules and during the comment process. The Dodd-Frank Act also accorded the CFPB supervisory and rulewriting authority over non-banks, including payday lenders, under certain circumstances.

The Dodd-Frank Act requires that the Federal Reserve and the CFPB coordinate aspects of their consumer compliance supervision of insured depository institutions and their affiliates, including scheduling of examinations; providing reciprocal opportunities to comment upon reports of examination prior to issuance; and reciprocally providing final reports of examination after issuance. In May 2012, the Federal Reserve and the other prudential regulators entered into a Memorandum of Understanding on Supervisory Coordination (MOU) with the CFPB. The MOU establishes arrangements for coordination and information sharing among the parties, as required under the Dodd-Frank Act. In addition, the Federal Reserve works with the CFPB and

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[1] Insured depository institutions supervised by the Federal Reserve are state member banks and insured state branches of foreign banking organizations.

other federal banking agencies through the FFIEC's Task Force on Consumer Compliance to develop interagency examination procedures.

As described above, the Dodd-Frank Act shifted certain federal consumer protection authorities and responsibilities to the CFPB, while others remained with the Federal Reserve. Further, the Federal Reserve's responsibility to ensure the safety and soundness of the U.S. banking system and of the banking organizations it supervises remained unchanged. For example, the Federal Reserve examines supervised institutions' anti-money laundering (AML) programs for compliance with the Bank Secrecy Act (BSA) and the USA PATRIOT Act. The Federal Reserve expects supervised institutions to implement appropriate BSA/AML policies and procedures, including regarding customer due diligence and transaction monitoring for suspicious activity. The FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) examination manual addresses relationships that pose higher BSA/AML risks due to the activities in which they engage, including those with businesses that use the banking organization to transfer funds. This guidance remains the policy of the Federal Reserve. It is not the Board's policy to discourage banking organizations from offering services to any class of financial service business operating within federal and state law. The Federal Reserve expects a banking organization that establishes relationships with customers engaging in higher-risk activities to identify the relevant risks and develop an effective monitoring regimen that addresses them.

Generally speaking, it is critical that all federal banking regulators work together as cooperatively and efficiently as possible. Clear lines of communication between the Federal Reserve and the CFPB have been essential to both entities in carrying out the work that ultimately impacts the other. As with other issues of mutual interest, Federal Reserve and CFPB staff have maintained an ongoing dialogue about issues relating to supervisory coordination, third-party payment processors and payday lending.

2. This question is regarding the recently proposed Liquidity Coverage Ratio (LCR), RIN 1557-AD74, treatment of municipal securities as non-High-Quality Liquid Assets (HQLA). I would appreciate clarification regarding the extent that your office considered various, unique differences in the municipal market when formulating the proposal. For example, did you consider the differences in so-called "dollar bonds," or those bonds of larger, frequent issuers, versus the bonds of less frequent issuers that trade based on yield.

The goal of the liquidity coverage ratio (LCR) is to ensure that covered companies are able to meet their short-term liquidity needs during times of stress. The inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. To ensure adequate liquidity, the final rule includes as high-quality liquid assets (HQLA) only securities that historically have been readily convertible into cash with little or no loss of value during a period of stress, either by sale or through a repurchase transaction. The OCC, FDIC, and Board considered various types of assets for treatment as HQLA and evaluated relevant market data relating to the liquidity characteristics.

Under the LCR final rule issued on September 3, 2014, securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) do not qualify as HQLA. However, the Board has reviewed market data regarding municipal securities and the information provided by commenters and is exploring the development of a new proposal for public comment to treat as HQLA for purposes of the LCR requirement municipal securities that trade readily and have liquidity characteristics that are comparable to other HQLA assets.

Questions for the Record
Financial Services Committee Hearing: "Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"
April 8, 2014

Representative Peter King

Questions for the FDIC, OCC and Federal Reserve on their proposed Liquidity Coverage Ratio rule: I am glad that representatives from the FDIC, OCC and the Fed are all here today, because I would like you all to comment on the Liquidity Coverage Ratio proposal your agencies put out to comply with the Basel Committee's requirements. I am particularly concerned about how the treatment of municipal securities and deposits will affect municipalities – including New York City and communities affected by Superstorm Sandy – which depend heavily on muni bonds to fund critical infrastructure. Can you explain why your agencies did not grant municipal bonds status as "High Quality Liquid Assets" (HQLA), despite the Basel Committee's recommendation to do so?

Response: HQLA are intended to be easily and immediately convertible into cash with little or no loss of value during a period of liquidity stress. In the preamble to the proposed Liquidity Coverage Ratio (LCR) rule, the agencies stated that municipal securities are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA. The banking agencies received many comments on the proposal related to municipal securities and are considering those comments as we develop a final LCR rule. The proposed LCR rule does not prohibit a bank from holding municipal securities, and the OCC expects banks will continue to make these types of investments.

Question: I understand that under your proposal corporate bonds and even sovereign debt were given HQLA treatment. Why is the debt of small nations whose sovereign securities are illiquid or even distressed, are treated as higher quality than securities from our own states and districts? Can you explain that decision?

Response: Under the proposal, securities that are issued or unconditionally guaranteed as to the timely payment of principal and interest by a sovereign entity would be HQLA. In the U.S., municipal securities are not unconditionally guaranteed by the federal government and, thus, do not qualify for HQLA under that proposed standard.

Furthermore, in order to qualify as HQLA, a sovereign security must be liquid and readily marketable and:

(A) Be assigned a zero percent risk weight under the U.S. capital rules and issued by a sovereign whose obligations have a proven record as a reliable source of liquidity in the repurchase and sales markets during stressed market conditions; <u>or</u>

(B) If the sovereign security is not assigned a zero percent risk weight under the U.S. capital rules and the sovereign issues the security in its own currency, a bank may use the security only to meet the bank's net cash outflows in the sovereign's jurisdiction.

Question: Your agencies' LCR proposal also treats municipal deposits as secured transactions under the rule which means they would be subject to a 100 percent unwind for purposes of the ratio calculation. I am concerned this will hamper municipalities' ability to seek the banking services they need to make pay-roll and fund day-to-day activities. Can you comment on why these deposits were treated as secured transactions under the proposal?

Response: The proposed rule treated municipal deposits as "secured funding transactions" because municipal deposits are required under state or municipal law to be collateralized. The proposal required banking organizations to unwind all secured funding transactions that mature within a 30 calendar day stress period in order to calculate HQLA. The reason for the proposal's unwind treatment is to ensure that banking organizations do not artificially inflate their HQLA amounts by entering into repurchase and reverse repurchase transactions. The agencies received many comments related to municipal deposits and the proposed unwind of secured funding transactions and are carefully considering those comments.

Representative Patrick E. Murphy

Mr. Osterman and Ms. Friend, Operation Chokepoint was designed to go after unlawful short-term lenders. I strongly support efforts to protect Floridians from predatory, illegal lenders. However, I'm hearing from banks that they are dumping legitimate, lawfully operating short-dollar lenders due to reputational risk. While reputational risk is an extremely important consideration for the health and well-being of a financial institution, the consequence of an overly broad reputational risk determination would have the impact of completely putting an end to low-dollar short-term loans. Without access to banking services, the short term, low dollar loan industry is done.

Not only will that undermine the good work that my state has done in regulating this industry, it will assume the authority, given by Congress to CFPB, which is taking a comprehensive, thoughtful approach. If financial regulators, under the guise of reputational risk, assume jurisdiction over short-term loans and effectively eliminate the product, it will cost Floridians both their hard-earned protections and their access to this type of credit.

- Is the agency intending to cut off banking services from low dollar lenders?
- Is the agency intending to shut down payday lending?
- If not, how are examiners working to protect institutions from reputational risk without assuming jurisdiction via enforcement and restricting access to short-term credit?

Response:

The OCC is not a part of the Department of Justice's Operation Choke Point. We do, however, cooperate with law enforcement investigations and the OCC routinely receives and processes requests for information from law enforcement agencies.

As a general matter, the OCC does not recommend or encourage banks to engage in the wholesale termination of categories of customer accounts (including small dollar and payday lenders). Rather, we expect banks to assess the risks posed by individual customers on a case-by-case basis and to implement appropriate controls to manage each relationship.

Outside of the enforcement context, the ultimate decision of whether to open, close, or maintain an account rests with the bank. In some cases, the bank may determine that it cannot effectively manage the risks on a cost-effective basis, and decide to close the account or exit a line of business. These are business decisions made by the bank itself and not dictated by the OCC. In fact, many banks have policies that call for them to close accounts based on certain criteria, such as after a certain number of Suspicious Activity Reports have been filed in connection with a customer, and we expect banks to comply with their own policies.

With respect to reputation risk, the OCC considers such risk to be an important factor in the evaluation of the safety and soundness of the institutions we supervise. However, the OCC recognizes that banking is a business of assuming risks, and thus we employ a supervisory approach focused on evaluating risk, identifying material and emerging problems, and ensuring that individual banks take their own corrective action before problems compromise their safe and sound operation.

Representative Gwen Moore

Question for Mr. Alvarez and Ms. Friend:

This question is regarding the recently proposed Liquidity Coverage Ratio (LCR), RIN 1557-AD74, treatment of municipal securities as non-High-Quality Liquid Assets (HQLA). I would appreciate clarification regarding the extent that your office considered various, unique differences in the municipal market when formulating the proposal. For example, did you consider the differences in so-called "dollar bonds," or those bonds of larger, frequent issuers, versus the bonds of less frequent issuers that trade based on yield.

Response: In developing the LCR proposal, the agencies reviewed the liquidity characteristics of municipal securities. For example, the agencies reviewed municipal securities' trading volumes, trading frequency, interest rate risk, and potential for price volatility. The banking agencies received many comments on the proposal related to municipal securities and are considering those comments as we develop a final LCR rule.

Congresswoman Kyrsten Sinema

Question for Richard J. Osterman, Acting General Counsel, Federal Deposit Insurance Corporation or Amy Friend, Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency

It is my understanding that Operation Choke Point is intended to eliminate fraud and illegal transactions from our nation's payment system. However, it has come to my attention that an online lead marketplace based in my district has been forced to lay off employees as a direct result of Operation Choke Point. What is being done to ensure that regulators are effectively eliminating predatory actors who are breaking existing laws and not unintentionally harming legitimate, lawful businesses?

Response:

The OCC is not a part of the Department of Justice's Operation Choke Point. We do, however, cooperate with law enforcement investigations and the OCC routinely receives and processes requests for information from law enforcement agencies.

As a general matter, the OCC does not recommend or encourage banks to engage in the wholesale termination of categories of customer accounts. Rather, we expect banks to assess the risks posed by individual customers on a case-by-case basis and to implement appropriate controls to manage each relationship. Under the Bank Secrecy Act, institutions must have systems and controls to monitor accounts appropriately for potential criminal violations and suspicious activity indicative of money laundering or terrorist financing. If we find significant weaknesses in a bank's systems and controls, we will require the bank to take appropriate corrective action. In more serious cases, we will require corrections through an enforcement action. In rare cases where a customer has engaged in suspected criminal or other illegal activity, or the bank cannot properly manage the risk of an activity, we may order the bank through an enforcement action to terminate the customer's account.

Outside of the enforcement context the ultimate decision of whether to open, close, or maintain an account rests with the bank. In some cases, the bank may determine that it cannot effectively manage the risks on a cost-effective basis, and decide to close the account or exit a line of business. These are business decisions made by the bank itself and not dictated by the OCC. In fact, many banks have policies that call for them to close accounts based on certain criteria, such as after a certain number of Suspicious Activity Reports have been filed in connection with a customer, and we expect banks to comply with their own policies.

Congressman Scott Garrett

The following questions to the OCC regarding the OCC's Volcker Rule Cost-Benefit Analysis (the "analysis").

Question 1: The OCC is the only agency to have conducted an economic cost-benefit analysis of the Volcker rule. Did the OCC share its analysis with other regulators promulgating the rule, prior to when the regulators voted on the rule, and if so how much advance time was given for them to review the analysis? Were any prior drafts of the analysis previously circulated? If so when were they circulated and to whom were they circulated?

Response: No, the OCC did not share its analysis with other agencies prior to when the regulators voted to approve the rule on December 10, 2013, nor were any drafts of the analysis previously circulated to other regulators. The OCC's economic cost-benefit analysis of the proposed Volcker regulations was publicly available.

Question 2: On page 1 of the analysis, the OCC estimates the cost of the rule at between $412 million and $4.3 billion for entities regulated by the OCC. What portion of that estimate is a one-time cost, and what portion represents an annual cost? The text of the analysis is unclear on that basic point.

Response: We estimate approximately $3.7 billion in one-time costs and approximately $2.6 billion in recurring costs over the next four years.[1] One-time costs include (i) up to approximately $3.6 billion associated with a decrease in demand following the imposition of the restriction on banks holding collateralized debt obligation and collateralized loan obligation assets (i.e., the haircut on impermissible covered funds) plus (ii) other one-time costs included in estimated compliance costs. The two largest components of one-time costs are for set-up costs associated with reporting requirements ($23.8 million) and establishing policies and procedures at the trading desk level ($16.5 million). The remaining one-time costs are related to renaming covered funds and systems costs (associated with data collection).

Recurring annual costs over the next four years are composed of the following three components (i) the cost of additional capital associated with holding permissible covered funds ($626.3 million), (ii) annual compliance costs ($1.9 billion), and (iii) additional OCC costs related to supervision ($40 million). In the analysis, estimates for recurring annual costs include the cost of additional capital that ranges from $147.2 million to $164.8 million, additional OCC costs related to supervision of approximately $10 million per year, and annual compliance costs that range from approximately $361 million to $526 million.

Question 3: On page 1 of the analysis, the OCC states that the final rule "will not have a significant economic impact on a substantial number of small OCC-supervised entities." But later the analysis admits that the rule will likely diminish liquidity and increase the bid-ask spread on affected products, which would clearly affect small OCC-regulated entities participating in the market for those products. Please explain that clear inconsistency.

Response: We do not see an inconsistency in the analysis between the Regulatory Flexibility Act (RFA) conclusion and the reference (on page 17) to research by Hasbrouck (2009) that points out that decreased liquidity would likely be associated with increased bid-ask spread transaction costs for stock market investors.

As required by the RFA, we assessed the impact of the rule to determine if it will have a significant economic impact on a substantial number of small entities and concluded that the final rule will not have a significant economic impact on a substantial number of small OCC-regulated entities because (based on our estimates) the final rule will have a significant economic impact on only seven small banks. Additionally, as we noted on page 24, only 12 (of 1,211 small OCC-regulated entities) had average trading assets greater than zero. Additionally, because OCC-regulated institutions are generally not permitted to hold equities, an increase in the bid-ask spread of equities should not have a material impact on most small OCC-regulated entities.

Question 4: In February Chair Yellen testified that "I wouldn't say that short-term proprietary trading was the main cause of the financial crisis." Do you agree with Chair Yellen?

Response: The financial crisis had a myriad of causes. Ultimately, Congress determined that short-term proprietary trading by insured depository institutions and their affiliates posed undue risks to the financial system that needed to be addressed. As the Comptroller noted in the statement he made when the Volcker regulations were approved, the Volcker Rule was one of the important

[1] The range of costs shown on page 1 of the analysis is for a one-year period. In contrast, this response details costs over a four-year period.

measures Congress adopted in the Dodd-Frank Act to ensure the safety and soundness of the U.S. banking system.

Question 5: On page 1 of the analysis, in describing the benefits of the Volcker rule, the OCC states that "certain benefits of the regulation can be difficult to quantify including the value of enhanced economic stability and benefits associated with reduced risk." How can a primary benefit of the Volcker Rule be economic stability if proprietary trading wasn't a major cause of the financial crisis?

Response: The Volcker Rule makes the financial system safer by prohibiting banks from engaging in the kinds of short-term trading activities that, as recently as 2012, resulted in several billions of dollars in losses, by preventing banks from bailing out funds in which they invest, and prohibiting banks from engaging in transactions that result in a material conflict of interest or material exposure to high-risk assets or high-risk trading strategies.

Question 6: Does the analysis comply with White House OMB Circular A-4?

Response: In general, OMB's Circular A-4 provides guidance on how those agencies that are required to comply with Executive Order (EO) 12866 should prepare an analysis to evaluate proposed rules and to learn if the benefits of a rule are likely to justify the costs. The OCC is not required to comply with EO 12866. However, consistent with the OCC's procedures, staff used Circular A-4 as a reference tool when they were developing the analysis, and the analysis is generally consistent with the circular's key elements.

Question 7: Are you aware that Circular A-4 requires the use of a pre-statute baseline in an analysis of this type?

Response: We do not interpret Circular A-4 to specify the use of a particular baseline. However, Circular A-4 does require that agencies "evaluate benefits and costs against the same baseline"— something the OCC does in its analyses.

Circular A-4 states that —

> "In some cases, substantial portions of a rule may simply restate statutory requirements that would be self-implementing, even in the absence of the regulatory action. In these cases, you should use a pre-statute baseline."[2]

As we note in our analysis, because the rules issued to implement section 619 of the Dodd-Frank Act do not simply restate statutory requirements the baseline represents 'the way the world would look absent the proposed action.'

Question 8: If you are determined to conduct an analysis that does not comply with the White House's standard, and use instead only a post-statute baseline for this analysis, did you include in the post-statute baseline an assumption that the baseline case would involve you utilizing your full authority to make exception for "any other activity determined by the Agencies, by rule, to promote

[2] See page 16.

and protect safety and soundness of the banking entity and the financial stability of the United States"?

Response: No, we did not include this assumption in our analysis. As noted in the response to Q7 above, because the baseline represents the way the world would look absent the regulatory action, the baseline does not include any assumptions about exceptions the Agencies did or did not include in the final rule. Moreover, in the final rule the Agencies did not exercise the exception authority referred to in the question.

Question 9: It remains unclear how the financial regulators responsible for implementing the Volcker rule intend to coordinate to ensure that agencies do not impose inconsistent requirements. Have you considered entering into a memorandum of understanding, with the other regulators implementing Volcker, to provide for mutual recognition with respect to agency guidance that a particular course of action does not violate the Volcker rule's prohibitions?

Response: The five rule-writing agencies have agreed to work together to develop consistent interpretations of the Volcker regulations. Agency staffs meet weekly to discuss issues raised and to develop responses to significant or frequently asked questions. On June 10, 2014, the OCC and the other four agencies published on their respective websites the first set of Frequently Asked Questions with uniform answers to six questions. These FAQs appear on the OCC's website at www.occ.gov/topics/capital-markets/financial-markets/trading/volcker-rule-implementation/volcker-rule-implementation-faqs.

Question 10: On page 14 of the analysis, you seem to equate the price impact on debt of a downgrade in an insurance company's credit rating with the price impact on debt of a significant decline in the liquidity of instruments resulting from a selloff required by the Volcker rule. How can you assume that a credit event and a regulatory event will have the same price impact? Are all events that might affect the value of corporate debt alike, such that they would all affect the cost of debt in exactly the same way? When the OCC regulates risk management of the banks it charters, does it assume that the different risks affecting the value of a bank's holdings are all equal in magnitude?

Response: The analysis does not equate "the price impact on debt of a downgrade in an insurance company's credit rating" to the possible "price impact on debt of a significant decline in the liquidity of instruments resulting from a selloff required by the Volcker rule." Nor does the analysis assume "that a credit event and a regulatory event will have the same price impact."

On page 14 of the analysis we use research findings from Ellul, et al. (2011)[3] that show how a decrease in demand "from regulated insurance companies that face regulatory restrictions" have a negative impact on corporate bond prices. Research by Ellul, et al. suggests that issuers' corporate bond prices drop roughly 11 percent following downgrades in issuers' credit ratings from investment grades to speculative grades. The authors show that bond prices drop following the downgrades because of the decrease in demand for these bonds by insurance companies that face regulatory restrictions in holding speculative grade bonds. Because the decrease in bond prices found by Ellul, et al. occurred following bond rating downgrades, we expect that part of the drop in

[3] Ellul, Andrew and Jotikasthira, Chotibhak and Lundblad, Christian T., "Regulatory Pressure and Fire Sales in the Corporate Bond Market," *Journal of Financial Economics*, 101,3 (September 2011).

prices they observed could have been due to both increased default risk and lower demand for the bonds.[4]

As we noted on page 14 of the analysis, because we are interested only in the decline associated with a lower demand, we also looked to research conducted by Longstaff, Mithal, and Neis (2005), who find that default risk explains 50 percent of the AAa/Aa corporate bond yield/Treasury yield spread.[5] Based on analysis from Longstaff, et al., we estimate that the market value of banks' investments in impermissible covered funds will drop 5.5 percent (11 percent X .50 = 5.5 percent due to decreased demand).

Question 11: The analysis references "non-monetized costs" on page 15. Does guidance on cost-benefit analysis from the White House Office of Management and Budget, including its Circular A-4, provide a framework to monetize those costs? If that White House guidance can provide a framework to monetize the impact of EPA or DOT regulation of environmental pollution or traffic safety regulations on human life, how can you assert that the costs and benefits you reference cannot be effectively monetized?

Response: The OCC does not assert in the analysis that the non-monetized costs cannot be quantified or monetized. In the analysis we state that "our cost estimate does not capture some costs that are quantifiable but difficult to estimate, such as indirect costs due to decreased market liquidity and the impact this decrease in liquidity may have on the market value of some assets and the cost to corporations of issuing debt." In our opinion, Circular A-4 does not provide a framework to monetize the costs described above that our estimate did not capture. Among other issues, Circular A-4 instructs agencies that they should not include transfer payments in the estimates of the benefits and costs of a regulation.[6] Cochrane (2014) observes that financial regulations essentially regulate transfers that would be neutral in cost-benefit analysis.[7]

Although Circular A-4 provides guidance, it does not provide a clear framework for monetizing all costs (or benefits). In addition to Circular A-4, there is extensive literature in economics establishing a framework for benefit-cost analysis (BCA) in environmental, health and safety, and antitrust analysis. However, Posner and Weyl (2013) note that they are not aware of "any analogous literature in financial economics."[8] Coates (2014) observes that quantifiable cost-benefit analysis (CBA) of financial rules such as the Volcker Rule would, among other things, be "highly contestable and sensitive to modeling assumptions."[9] Additionally, Cochrane (2014) notes that financial cause and effect is nebulous and that CBA requires a codification of procedure such as

[4] Ellul, et al. show that after 35 weeks the price drop is reversed because other market participants step in and purchase the excess supply of bonds. We anticipate a drop in the prices — or fair value — that would not reverse once the market becomes aware of the rule's restrictions because of the illiquid nature of the market for Collateralized Debt Obligation and Collateralized Loan Obligation assets held by banking entities.
[5] Longstaff, Francis, Sanjay Mithal, Eric Neis, "Corporate Yield Spreads: Default Risk or Liquidity? New Evidence from the Credit Default Swap Market," *The Journal of Finance*, 60,5 (October 2005).
[6] See page 38. "Transfer payments are monetary payments from one group to another that do not affect total resources available to society."
[7] Cochrane, John H., Cost-Benefit Analysis for Financial Regulation, (February 26, 2014).
[8] Posner, Eric A. and Weyl, E. Glen, Benefit-Cost Analysis for Financial Regulation, (January 10, 2013), *American Economic Review*, Vol. 103, No. 3, 2013.
[9] Coates, IV, John C., Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, (January 6, 2014), European Corporate Governance Institute (ECGI) - Law Working Paper No. 234/2014; Harvard Public Law Working Paper No. 14-05.

"what constitutes acceptable 'science,' [and] which cause and effect mechanisms matter [and that the] state of knowledge and professional agreement in financial economics does not approach this state."[10]

Question 12: On page 17 the analysis references the impact of reduced liquidity on the bid-ask spreads in equity markets. Did you perform a similar analysis for the bond market?

Response: No.

Question 13: On page 21 of the analysis, you seem to embrace the argument that stock market liquidity is harmful. Instead you suggest that financial regulators should adopt rules designed to limit liquidity and make it more difficult for shareholders to exit their positions. Such a policy would have considerable wealth effects on the cost of trading for retail investors. It also appears to stand at odds with the Securities and Exchange Commission's longstanding policy of encouraging material and accurate disclosure to investors to encourage the price discovery function of capital markets. You may be aware that meaningful price discovery requires active trading in liquid markets. Does your position in this analysis represent a fundamental disagreement between the SEC and the OCC that could imperil efforts to coordinate between the two agencies going forward?

Response: We do not believe that stock market liquidity is harmful. Nor does the analysis state or suggest that "financial regulators should adopt rules designed to limit liquidity and make it more difficult for shareholders to exit their positions." Our analysis was not intended to suggest a disagreement between the SEC and the OCC.

The following question is to the FRB, CFPB, OCC, FDIC and NCUA (the Agencies) regarding the nonbank SIFI designation process.

I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations or statutory language that restrict FSOC voting members (the Agencies' principals), from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NDP) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on NPD.

Response: There are no FSOC-related rules or regulations that govern or restrict an FSOC principal from meeting with firms that are under consideration by FSOC for a non-bank SIFI designation. However, because such decisions are formal, appealable actions, the Council generally discourages individual meetings with Council members in order to ensure that all Council members consider the same information for any designation decision. It is important to note that there are extensive conversations between a firm and Council members' staffs before any final designation decision is made. This process begins with a written notice from the Council that the Council is considering whether to make a proposed determination and invites the firm to provide additional material. This

[10] Cochrane, John H., Cost-Benefit Analysis as a Framework for Financial Regulation (February 16, 2014).

notice is followed shortly thereafter with a detailed list of questions from FSOC to the firm for specific information and data that the Council intends to analyze when making its assessment. The information request is organized by the transmission channels that the Council published in its interpretative guidance and provides a roadmap of the key risk factors and metrics that the Council intends to explore. This stage of the process is iterative, and firms have the opportunity to respond to any preliminary assessments through the submission of written materials and meetings and discussions with Council staff. This stage of the designation process typically spans a number of months and involves numerous meetings and follow up discussions between the firm and staffs regarding the materials submitted by the firm. Throughout the process, senior members of FSOC and Council member' staffs are kept informed of the nature of the discussions and are invited to participate in meetings with the firm. The materials and arguments presented by the firm against its designation are summarized in the case decision memorandum provided by staff to Council members and are part of the Council's administrative record. Council members have full access to any and all of the detailed information submitted by a firm should they want to review that information.

"Who's in Your Wallet:
Examining How Washington Red Tape Impairs Economic Freedom"
House Committee on Financial Services Hearing
April 8, 2014

Meredith Fuchs, General Counsel
Consumer Financial Protection Bureau

Questions for the Record Submitted by Rep. Andy Barr:

1. Ms. Fuchs, in previous hearings before this Committee, Director Cordray indicated that the CFPB is looking at possible changes to mortgage rules, including a re-evaluation of the definition of rural areas. When can we expect these revisions to become finalized? In this evaluation, will the Bureau look at minimizing burdens on community financial institutions? If not, why not?

Response:

The Consumer Financial Protection Bureau (Bureau) is providing a two-year transition period during which small creditors can originate balloon payment qualified mortgages even if they do not operate predominantly in rural or underserved areas. In addition to providing time for small creditors to further develop their capacity to offer adjustable-rate mortgages, the Bureau expects to re-examine the definitions of rural or underserved during this time to determine, among other things, whether these definitions accurately identify communities in which there are limitations on access to credit and whether it is feasible to develop definitions that are more accurate or more precise. The Bureau is in the process of research and analysis to deepen our understanding of small creditors' origination of both balloon and adjustable rate mortgages and the implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions on access to credit. The Bureau is taking a holistic approach to better understand the issues regarding consumer protection, state regulation, technical systems, compliance processes, credit risk management, and other considerations that prompt small creditors to offer balloon loan products, and the potential transition issues in converting to other loan offerings. These efforts are being undertaken for the purpose of ensuring access to markets for consumer financial products and services for all consumers, while seeking to minimize burdens on financial institutions. This is a complicated topic that requires time.

Questions for the Record Submitted by Rep. Keith Ellison:

1. I have reviewed the consent order between the Department of Justice, CFPB and Ally Financial Inc. and Ally Bank, which required Ally to pay $80 million in damages to 235,000 minority borrowers who paid higher interest rates for their auto loans relative to similarly situated non-Hispanic white borrowers. In addition, Ally was also ordered to pay $18 million in penalties: http://www.consumerfinance.gov/newsroom/cfpb-and-doj-order-ally-to-pay-80-million-toconsumers-harmed-by-discriminatory-auto-loan-pricing/.

This order is the federal government's largest-ever auto loan discrimination settlement. I am pleased to see CFPB's strong response to discriminatory practices in lending markets.

a. I understand that the CFPB cannot discuss current investigations, however, can you tell me how many cases the CFPB referred to the Department of Justice as possible violations of the Equal Credit Opportunity Act regarding possible discrimination in auto lending?

Response:

The Consumer Financial Protection Bureau (Bureau), along with the other federal agencies which have responsibility for enforcement of the Equal Credit Opportunity Act (ECOA), refers certain matters to the Department of Justice (DOJ) when it has reason to believe that a creditor has engaged in a pattern or practice of lending discrimination. In our recent Fair Lending Report[1], we stated that the Bureau made one auto lending-related referral to the DOJ, and subsequently took joint enforcement action with the DOJ against that indirect auto lender for violations of ECOA. Since the period covered in the report, the Bureau has referred several additional auto lending-related matters to the DOJ.

b. Can you tell us what the CFPB has discovered generally with regard to policies that exist in the indirect auto lending market that may have resulted in higher interest rates or less favorable loans provided to African American, Latino and Asian Pacific American borrowers?

Response:

As noted in the Bureau's bulletin, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act*[2] (Auto Bulletin), many of the indirect auto lenders subject to the Bureau's supervisory authority have policies that allow auto dealers discretion to mark up established buy rates and compensate dealers based on those markups. Historically, the failure to properly or consistently monitor discretionary policies and practices for compliance with anti-discrimination laws has been a contributing factor in discrimination in auto lending and in other product

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[1] *See* Consumer Financial Protection Bureau, *Fair Lending Report of the Consumer Financial Protection Bureau* (Apr. 30, 2014), *available at* http://files.consumerfinance.gov/f/201404_cfpb_report_fair-lending.pdf.

[2] Consumer Financial Protection Bureau, CFPB Bulletin 2013-02, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act* (Mar. 21, 2013), *available at* http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.

markets, like mortgages. This pattern has been documented by scholars[3] and is reflected in relevant case law[4] and DOJ enforcement actions.[5]

c. On March 21, 2013, the CFPB published guidance on Fair Lending Practices to Indirect Auto Lenders: http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-to-hold-auto-lenders-accountable-for-illegal-discriminatory-markup/. What led the Bureau to issue this guidance? Why was guidance issued instead of a regulation?

Response:

As you know, the ECOA and its implementing regulation, Regulation B, which was the result of notice and comment, make it illegal for a "creditor" to discriminate in any aspect of a credit transaction because of race, color, religion, national origin, sex, marital status, age, receipt of income from any public assistance program, or the exercise, in good faith, of a right under the Consumer Credit Protection Act.

Many of the indirect auto lenders subject to the Bureau's supervisory authority have policies that allow auto dealers discretion to mark up established buy rates and compensate dealers based on those markups. As noted in the Auto Bulletin, "Because of the incentives these policies create, and the discretion they permit, there is a significant risk that they will result in pricing disparities on the basis of race, national origin, and potentially other prohibited bases." The Auto Bulletin did not set forth substantiated findings of discrimination, but instead highlighted the fair lending risk inherent in some indirect auto lenders' markup and compensation polices based on the discretion the policies permit.

In addition, the Auto Bulletin explained that the standard practices of indirect auto lenders can make them "creditors" under ECOA and was designed to help indirect auto lenders recognize and mitigate the risk of discrimination resulting from discretionary dealer markup and compensation policies. The Auto Bulletin also described steps that indirect auto lenders might

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[3] For example, *see* Cohen, Mark A. (2012). "Imperfect Competition in Auto Lending: Subjective Markups, Racial Disparity, and Class Action Litigation." Review of Law and Economics vol. 8, no. I (21-58). Working Paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951827.

[4] *See* Coleman v. Gen. Motors Acceptance Corp., 196 F.R.D. 315 (M.D.Tenn. 2000), *vacated and remanded on unrelated grounds,* 296 F.3d 443 (6th Cir. 2002); Jones v. Ford Motor Credit Co., 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002); Smith v. Chrysler Fin. Co., 2003 WL 3287 I 9 (D.N.J. Jan. I 5, 2003); Osborne v. Bank of America Nat' I Ass'n, 234 F.Supp.2d 804 (M.D. Tenn. 2002); Wise v. Union Acceptance Corp., 2002 WL 31730920 (S.D. Ind. Nov. 19, 2002).

[5] *See, e.g.* , United States v. Springfield Ford, Inc., No. 2:07-cv-03469-PBT (E.D. Pa. Aug. 21, 2007); United States v. Pacifico Ford, Inc., No. 2:07-cv-03470-PBT (E.D. Pa. Aug. 18, 2007); United States v. NARA Bank, et al., No. 2:09-cv-07124-RGK-JC (C.D. Cal. Nov. I 8, 2009); *see also* United States v. Countrywide Fin. Corp. No.2:11-cv-10540-PCG-AJW (C.D. Cal. Dec. 28, 2011); United States v. AIG Fed. Sav. Bank, No. 1:99-mc-0999 (D. Del. Mar. 4, 2010).

take to ensure they are operating in compliance with fair lending laws. Importantly, the Auto Bulletin made clear that there are many possible paths forward for lenders. It also emphasized that dealers should be fairly compensated and did not in any way foreclose consumers' ability to negotiate their interest rate on an auto loan.

Finally, because the Auto Bulletin served to remind institutions of their legal responsibilities under existing law, it was appropriate to issue guidance, rather than a regulation. The guidance provided suggestions for mitigating legal risks; it did not establish additional legal requirements for either the public or for the Bureau. Rather, the Auto Bulletin provided examples of internal controls, program features, and compliance management systems that institutions might use to mitigate legal risk.

2. Is the CFPB familiar with the Center for Responsible Lending's (CRL) January 2014 research, *Non-negotiable: Negotiation Doesn't Help African Americans and Latinos in Dealer-Financed Car Loans?* http:/ /www.responsiblelending.org/ other-consumer-loans/auto-financing/researchanalysis/CRL-Auto-Non-Neg-Report.pdf.

   The study surveyed more than 900 consumers who recently bought cars. CRL found that African Americans and Latinos attempt to negotiate loan pricing with car dealers more often than white consumers: 39% of Latinos and 32% of African Americans reported negotiating their interest rate, compared to only 22% of white respondents. Yet white car buyers reported receiving lower interest rates—even those who didn't try to negotiate at all. Previous research has shown that interest rate disparities persist even when controlling for credit differences. The report identifies three factors that can add unnecessary costs to car loans made by dealers: 1) hidden dealer increases in the interest rate ("markups"), 2) misleading information that leads consumers to stop negotiating the interest rate, and 3) add-on products, such as insurance and warranties. In addition to getting higher interest rates, African Americans and Latinos also reported more instances of receiving misleading information, and they were nearly twice as likely as white consumers to be sold multiple add-on products.

   Will the CFPB review the research from consumer groups whose research shows disparities in pricing by ethnicity? How will the CFPB build on this research?

Response:

Yes, the Consumer Financial Protection Bureau (Bureau) has seen and reviewed this study by the Center for Responsible Lending. The Bureau regularly considers input from a variety of external and internal stakeholders to inform our risk-based prioritization process, which seeks to make the best use of our research, examination, and enforcement resources. Our risk-based prioritization approach reflects entities, products, and markets under our jurisdiction, including assessing fair lending risk to consumers, through many qualitative and quantitative factors to determine what, where, and how risks to consumers should be addressed. These factors include: complaints and tips from consumers, advocacy groups, whistleblowers, and other government agencies; supervisory and enforcement history; quality of lenders' compliance management systems; data

analysis; and market insights, such as factors and trends identified by our Division of Research, Markets, and Regulations, as well as independent research, such as the study you highlighted. The Bureau integrates this information into the fair lending prioritization process, which is incorporated into the Bureau's larger risk-based prioritization process, allowing the Bureau to efficiently allocate its fair lending resources to the areas of greater risk to consumers.

Questions for the Record Submitted by Rep. Scott Garrett:

1. I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations or statutory language that restrict FSOC voting members (the Agencies' principals), from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NPD) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD. Do the Agencies support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on a NPD.

Response:

The Financial Stability Oversight Council (FSOC) regulations implement a careful process for potential designation of nonbank financial institutions for supervision by the Board of Governors of the Federal Reserve System, and to be subject to prudential standards, in accordance with Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, those firms in Stage 3 interact closely with FSOC staff and are able to provide any information relevant to a particular potential designation. While this process does not currently afford an opportunity for the firm under consideration to meet with Principals at this stage, one firm did recently meet with the Deputies Committee while in Stage 3. Consistent with the rules, after a Notice of Proposed Designation, the specific firm can request a hearing with Principals and to date, one firm has taken that opportunity.

Questions for the Record Submitted by Rep. Bill Huizenga:

1. The Dodd Frank Act gives the CFPB the authority to provide exemptions from its rules for certain classes of institutions. We have heard from credit unions and small banks about the ever increasing regulatory burden the Bureau's rules place on them, even though there is little—if any evidence to support an argument that they are treating consumer poorly. Why hasn't the Bureau done more to focus its rulemaking on the bad actors in the financial services sector, as oppose to imposing additional burden on credit unions and small banks? Does the Bureau intend to use its authority to exempt these institutions from its rulemaking in the future? If not, why not?

Response:

The Consumer Financial Protection Bureau (Bureau) also shares your concern that regulations should not place unnecessary burdens on credit unions and small banks. We recognize that, with few exceptions, credit unions and small banks did not engage in the type of risky lending that led to the mortgage crisis. We also understand that if the regulations implementing the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act are unnecessarily burdensome, these institutions may be more likely to retreat from the market, which could restrict access to credit for some.

For these reasons, the Bureau takes special care to ensure that its rules are balanced for credit unions and the consumers they serve. For instance, the Bureau has tailored the Ability-to-Repay rule and the standards for qualified mortgages (QM) to encourage small creditors to continue providing certain credit products, while carefully balancing consumer protections. To address concerns such as those you raised, the Bureau created a QM provision specifically for small-creditor portfolio loans, which covers the vast majority of credit unions and small banks.

2. There are many who are concerned that the QM rule will constrain mortgage credit after the exemption for GSE-compliant loans expires. One recommendation would be to increase the threshold for "small loans" from $100,000, as the rule now allows, to $200,000. This would increase the availability of credit to first-time and moderate-income borrowers.

    a. Do you have the legal authority to increase this amount?

Response:

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) limits the points and fees payable in connection with a loan that is a qualified mortgage (QM) to 3 percent of the total loan amount. The Act also requires that the Consumer Financial Protection Bureau (Bureau) prescribe rules adjusting this limit to permit lenders that extend smaller loans to meet the QM requirements. However, the Act did not define the threshold for "smaller loans."

    b. If so, why haven't you increased this threshold?

Response:

The Federal Reserve Board, which originally had authority for implementing the Dodd-Frank Act before that authority transferred to the Bureau, proposed a threshold of $75,000 for "smaller loans." The Bureau increased this "smaller loan" threshold to the current $100,000 (indexed for inflation). The Bureau also carefully designed a tiered sliding scale system that allows smaller dollar loans to be qualified mortgages even when the total points and fees are greater than three percent of the total amount of the loan. The permissible relative share of points and fees percentage increases as the loan amount declines to reflect the fact that fixed costs represent an increased percentage of the loan amount for smaller loans. For the very smallest loans, the limit

is 8 percent of the total loan amount. This threshold and tiered sliding scale apply to all QMs, including the current Government Sponsored Enterprises (GSE) eligible QMs. Thus the question of whether to raise the threshold is not necessarily related to the expiration of the GSE-eligible QM definition.

c. If not, would you support legislation that would require that you increase the threshold for small loans to ensure low-income consumers can have access to mortgage credit?

Response:

The Bureau generally does not take a position for or against prospective legislation. The Bureau strives to implement its statutory mandates faithfully and fairly and has made every effort to ensure that access to mortgage credit is fair and transparent.

3. What legal liability does a lender face for originating a non-Qualified Mortgage that is ultimately found not to comply with the ability-to-repay requirement? Given these risks, do you believe that lenders will originate non-Qualified Mortgages? Or will they avoid these mortgages altogether?

Response:

The Truth in Lending Act (TILA), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), provides that a consumer who brings a timely action against a creditor for a violation of the ability-to-repay (ATR) requirement may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the consumer for up to three years, unless the creditor demonstrates that the failure to comply is not material.[6] This recovery is in addition to: (1) actual damages; (2) statutory damages in an individual action or class action, up to a prescribed threshold; and (3) court costs and attorney fees that would be available for violations of other TILA provisions. Moreover, when a creditor, or an assignee, other holder, or their agent initiates a foreclosure action, a consumer may assert a violation of the ATR requirement "as a matter of defense by recoupment or setoff." There is no time limit on the use of this defense. However, the amount of recoupment or setoff is limited, with respect to the special statutory damages, to no more than three years of finance charges and fees. The Bureau has noted that the longer a consumer successfully makes timely payments, the less likely it is that the creditor's determination of ability to repay was unreasonable or not in good faith.

In finalizing the ATR requirement, the Bureau estimated that the litigation costs associated with non-qualified mortgage loans could be expected to add less than 10 basis points (0.1 percentage points) to an average consumer's mortgage rate.

[6] *See* 15 U.S.C. § 1640(a)(4), (e), (k)(2)(B).

The Dodd-Frank Act carefully cabins the conditions under which claims can be asserted and damages can be awarded. The final rule provides extensive and clear guidance on how to comply with the ATR/Qualified Mortgage (QM) rule. As done throughout the implementation periods for other mortgage rulemakings, the Bureau continues to work with industry to ensure that the ATR/QM rule is implemented as intended. The Bureau's goal is to avoid industry confusion or lack of communication.

We expect there will be plenty of responsible loans that fall outside our QM standard. There are good loans made every year – for example, loans made to a borrower with considerable other assets or whose individual circumstances and repayment ability are carefully assessed, which are non-QM because they do not meet the 43 percent debt-to-income ratio or are not eligible for purchase by the government-sponsored entities, but nonetheless are based on sound underwriting standards and routinely perform well over time.

4. We are already seeing the first signs that some smaller community financial institutions are throwing their hands up in frustration and exiting the mortgage business rather than trying to navigate the liability risk and excessive compliance costs inflicted by the CFPB's QM rule. Indeed, a recent American Banker headline has suggested that "QM" will come to stand for "Quitting Mortgages."

    a. How do you reconcile the one-size-fits-all approach taken by the CFPB in promulgating the QM rule with your statutory obligation to promote consumer choice and facilitate access and innovation in the marketplace?

Response:

The Consumer Financial Protection Bureau (Bureau) has not taken a one-size-fits-all approach to the Ability to Repay/Qualified Mortgage (ATR/QM) rule. Access to credit in rural communities as well as the impacts of our rules on small creditors who serve those and other communities is a matter we take very seriously. Bureau staff has undertaken numerous meetings with small creditors and their trade associations. The Bureau has also consulted our Credit Union and Community Banking advisory councils for feedback.

We have provided specialized QM rules designed to facilitate compliance and preserve access to credit from small creditors. Generally speaking, small creditors are ones that are $2 billion or less in assets, and together with their affiliates, do 500 or fewer first lien mortgage loans per year. Where a small creditor holds the loan in portfolio for at least three years, it can take advantage of these special QM rules. Such loans issued by small creditors are QMs even if they exceed the 43 percent debt-to-income (DTI) ratio, as long as the creditor considered DTI or residual income and the loans meet the basic product features for QMs. The final rule also allows small creditors to charge a higher annual percentage rate and still qualify for the Safe Harbor (Annual Percentage Rate (APR) <= 350 basis points over Average Prime Offer Rate (APOR) vs. 150 basis points over APOR).

In addition to the balloon payment QM for creditors operating predominantly in rural or underserved areas, our rules also provide a two-year temporary QM for small creditors that are making balloon loans that they hold in portfolio without regard to where the creditor operates. In other words, small creditors across the country can make balloon loans (with certain limitations such as a required loan term of at least five years) as QM loans for two years after the rule goes into effect. During this period, our staff has committed to studying the topic of small creditor balloon loans further, especially with regard to access to credit in rural or underserved communities. In so doing, the Bureau intends to review whether the definitions of rural or underserved should be further adjusted for purposes of the QM rule.

Questions for the Record Submitted by Rep. Patrick Murphy:

1. Ms. Fuchs, the Bureau has been thoughtful in its approach to protecting consumers and responsive to industry concerns about unintended consequences of regulations like QM. The thoughtfulness with which the Bureau is approaching regulation of the payday loan industry is also commendable. I believe that consumers must be protected from predatory lenders and unlawful actors. As you know, my home State of Florida combines good consumer protections with great enforcement. This protects consumers from abuse without constricting access to capital. Our well-regulated system crowds out offshore and unlawful online lenders that prey on consumers. How is the Bureau doing outreach to stakeholders and consumers in regulating this industry?

Response:

The Consumer Financial Protection Bureau (Bureau) engages a wide range of stakeholders and consumers in its work regarding the payday loan industry. The Bureau's approach is grounded in understanding the consumer experience in the payday loan market and data-driven evidence. Field hearings are an important engagement opportunity for the Bureau around major consumer financial issues. The Bureau, so far, has held two field hearings dedicated to the topic. One field hearing was in Birmingham, Alabama in January 2012, and the other was in Nashville, Tennessee in March 2014.

The Bureau has an open door for those interested in sharing their experiences, concerns, and recommendations. The Bureau's External Affairs division and those across the Bureau responsible for developing proposed rules impacting the payday lending market meet regularly with industry, government, and consumer stakeholders. The Bureau will continue to solicit and consider input from stakeholders as we consider how to develop proposed regulations.

Additionally, the Bureau recognizes the important role of the states in the consumer financial marketplace. As the Bureau considers appropriate regulatory action in the market for payday loans, we will carefully examine the consumer protections developed by the states.

Questions for the Record Submitted by Rep. Robert Pittenger:

1. I appreciated that your written statement indicated that the Bureau is, "committed to ensuring that our rules are effective at protecting consumers and making consumer financial markets work better, and that they do not unduly burden the institutions participating in those markets." Your statement also indicated that among the strategies the Bureau employ to achieve those goals is to consider input from a wide variety of stakeholders and you said that you seek targeted input on specific regulations. You mentioned the Bureau's use of Small Business Regulatory Enforcement Fairness Act (SBREFA) to solicit feedback from small businesses.

    a. Why does the Bureau provide just two weeks notice of the meetings to SBREFA participants? Some SBREFA participants have said they had to spend a lot of money to make last minute travel arrangements. Would the Bureau give small entity representatives at least one months' notice so that they can make travel arrangements to attend SBREFA panel meetings in person?

Response:

The Consumer Financial Protection Bureau (Bureau) recognizes that Small Business Regulatory Enforcement Fairness Act (SBREFA) small entity meeting participants need adequate time to make travel arrangements, review materials, and prepare for and participate in SBREFA meetings. The Bureau's most recent SBREFA meeting with small entity representatives was held on March 6, 2014, in connection with a proposed rulemaking under development to implement amendments to the Home Mortgage Disclosure Act (HMDA) required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and to make related changes to the Bureau's Regulation C.[7] The Bureau began communicating with potential small entity representatives for the HMDA SBREFA Panel over a month in advance of the March 6th meeting. Written materials for the Panel meeting were circulated to the selected SBREFA small entity representatives on February 7, 2014. Throughout the month of February, the Panel held three teleconferences with the SBFEFA meeting participants to provide information about the SBREFA process and discuss matters related to the Bureau's analysis and the specific proposals under consideration. All small entity representatives were provided with the option to participate in the March 6th SBREFA Panel meeting by teleconference if unable to travel or attend in person. The Bureau also provided the small entity representatives with an opportunity to submit written feedback until March 20, 2014.

    b. Why does the Bureau not consult with industry trade associations before SBREFA panels are convened to better prepare the small entity representatives for the SBREFA panels? One of the main goals of these panels is to help determine how costly a regulation will be to implement for small business and to identify less-costly alternatives. Industry groups can help the Bureau measure factors included in these cost estimates (including differences in regional practice and vendor practices) or information about alternatives that can reduce costs for small businesses. A small

[7] 12 CFR part 1003.

business owner can provide more effective information to the SBREFA process when they have the assistance from their trade association or their vendors. Conducting outreach to trade associations before holding the panel (including inviting trade associations to observe the panel meeting in person) ensures that the SBAR gets the most accurate cost data available.

Response:

SBREFA Panels are one part of the Bureau's broader outreach initiatives to consult with and obtain feedback from small businesses and other stakeholders. The Bureau engages in a variety of other outreach efforts to obtain information and feedback from industry stakeholders and their trade associations, representatives, and vendors, as well as from consumers and consumer advocates.

The Bureau allows and enables small business representatives to seek and obtain the assistance and support of their trade associations or vendors if they so desire. The Bureau's substantive written materials describing the proposed rule under consideration and its potential impacts are not only distributed to the participants in the meeting, but also are published and made available to all members of the public, including trade associations, vendors, and other industry representatives, on the Bureau's website. In addition, for each of the four SBREFA panel meetings held by the Bureau to date, each small entity representative was able to invite and bring at least one guest, which could be someone from their own company, a trade association, or vendor, with them to provide support and assistance during and after the SBREFA Panel meeting. As a result, trade associations and vendors are able to provide any assistance or support if a small business representative seeks such assistance during the SBREFA process.

c. Why does the Bureau not make the SBREFA panel report public once it is complete and wait until the final regulation is published? By publicizing the report earlier in the regulatory process, the Bureau can provide crucial information to industry stakeholders. This will allow industry to develop more useful data for the Bureau to consider about the impact of their proposals on small business.

Response:

The Regulatory Flexibility Act, as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 and the Dodd-Frank Act, requires the SBREFA Panel report be made public as part of the rulemaking record but does not specify when the report should be released to the public.[8] The Bureau does not wait until the final regulation is published before releasing the SBREFA Panel report to the public as part of the rulemaking record. Rather, the Bureau releases the SBREFA Panel report with the proposed rule so that the public, including small entities and other industry stakeholders, can consider them together and submit formal comments in response to the proposal.

[8] *See* 5 U.S.C. 609(b)(5).

In addition, for each of the four SBREFA panel meetings held by the Bureau to date, substantive written materials describing the proposed rule under consideration and its potential impacts were not only distributed to the small entity representatives participating in the meeting, but were also made available to the public, including other industry stakeholders, on the Bureau's website. This provides an opportunity to all industry stakeholders – not just SBREFA Panel meeting participants – to review and assess the proposals under consideration and submit any data, comments, or other information related to potential impacts of the proposal to the Bureau for consideration prior to the issuance of the proposed rule.

d. Would the Bureau broaden the way it looks at the impact of a regulation on small business. The SBREFA panel focused heavily on the direct costs of this rule on small business, such as software costs, productivity and training but glanced over the parts of this rule that could have indirect but very serious costs on small business. These indirect costs can be extraordinary, including potentially preventing small business from being able to compete in the future marketplace.

Response:

The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 and the Dodd-Frank Act, requires the Bureau to consult with small entities and collect advice and recommendations regarding the projected reporting, record keeping, and other compliance requirements of the proposed rule; other rules that may duplicate, overlap, or conflict with the proposed rule; and any significant alternatives which accomplish the stated statutory objectives and minimize any significant impact of the proposed rule on small entities.[9] When assessing such impacts under the RFA, the Bureau considers both one-time and recurring costs to small entities.

In addition, pursuant to the requirements of the RFA, the Bureau consults with small entities and collects advice and recommendations regarding: (1) any projected increase in the cost of credit for small entities; and (2) any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any increase in the cost of credit for small entities.[10] Other statutes such as the Paperwork Reduction Act (PRA)[11] and the Dodd-Frank Act,[12] also require the Bureau to consider impacts of it regulations.

e. An example is the panel's review of the proposals related to who completes the Closing Disclosure. Under the rule, the Bureau makes the lender ultimately liable for the accuracy of the Closing Disclosure even if they partner with a settlement agent to complete the form. While the panel focused on the direct costs of their new form, the indirect costs (namely that lenders would be incentivized to limit the number of small entities with whom they work) will be much more devastating to small business. The

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[9] *See* 5 U.S.C. § 603(b).
[10] *See* 5 U.S.C. § 603(d)(2).
[11] *See* 44 U.S.C. § 3501 et. seq.
[12] *See* 12 U.S.C. § 5512(b).

Bureau should take greater care to determine whether a proposal will cause business-model shifts that could be harmful to small-business competitiveness.

Response:

Throughout the rulemaking process, including during SBREFA, the Bureau received and considered comments regarding concerns about lender responsibility for the accuracy of the Closing Disclosure. During the SBREFA process, the panel recommended two alternatives after hearing concerns on this issue: (1) making the lender solely responsible for the settlement disclosure, and (2) making the lender and settlement agent responsible for TILA and RESPA portions, respectively, and making the lender and seller jointly responsible for providing the disclosure to the consumer. Following the panel's recommendation, the Bureau proposed two alternatives: (1) making the creditor solely responsible for provision of the Closing Disclosure and (2) permitting the settlement agent to provide the Closing Disclosure, although requiring the creditor ensures that the disclosure was provided in accordance with Regulation Z's requirements. After notice and comment, the Bureau considered and summarized comments received in the final rule, and finalized a rule permitting the settlement agent to provide the Closing Disclosure. The Bureau acknowledges that lenders may assume greater responsibility for the disclosure of settlement cost information than they do currently; however, the Bureau also believes that lenders will continue to rely on the expertise of settlement agents in conducting closings. Lender responsibility under this rule also aligns with current practices and allows the parties to continue to work together to close home mortgage transactions in a manner that is most efficient for consumers and the market. Under the final rule, settlement agents are, however, still responsible for providing the seller's Closing Disclosure. The rule also allows lenders to contract with settlement agents, which offers lenders additional flexibility in how they choose to structure their operations.

2. SBREFA panels are a one shot event that comes late in the regulatory process. The SBAR occurs after the Bureau has decided on the need for a regulation, conducted research to support the regulation, and developed the substantive pieces of the regulation and just prior to a regulation being formally proposed in the Federal Register. This is fairly late in the game and precludes the Bureau from considering, researching and testing alternatives that will be less costly to small business before publishing their proposal. A more effective process would be to have the Bureau consult with small businesses throughout the entire regulatory process.

   While I am not asking the Bureau to endorse specific legislation, does the Bureau see a benefit in the establishment of an advisory board for small businesses that are nondepository institutions similar to those established for outreach to community banks and credit unions? If no, why not?

Response:

The Regulatory Flexibility Act (RFA) requires the Consumer Financial Protection Bureau (Bureau) to convene a Small Business Regulatory Enforcement Fairness Act (SBREFA) Panel to consult with small entities and prepare an initial regulatory flexibility analysis and final

regulatory flexibility analysis for rules for which notice and comment are required unless it certifies that a rule will not have a "significant economic impact on a substantial number of small entities" (RFA impact).[13]

Small businesses have several opportunities to participate meaningfully in the SBREFA process. Prior to the SBREFA process, the Bureau generally conducts outreach through trade associations, our standing community bank and credit union advisory councils, informal roundtables, and other means to identify issues, alternatives, and impacts that will need to be assessed in the course of the rulemaking. The Bureau gathers and analyzes information as early in the rulemaking process as possible to determine whether to convene a SBREFA Panel. When a proposed rule under consideration is sufficiently developed so that small businesses can provide meaningful input and information on the potential RFA impacts and ways to minimize such impacts, the Bureau convenes the SBREFA Panel and consults with small business representatives.

In addition to the SBREFA panel, the Bureau publishes the materials on our website, creates a general email address to receive feedback, and typically, convenes several listening sessions to gather input from a broad range of stakeholders. Small businesses and their trade associations (including those consulted during the SBREFA process) get a full opportunity to submit comments on the Notice of Proposed Rulemaking once we have incorporated the earlier rounds of feedback to settle on a proposed approach.

In addition to the SBREFA process, the Bureau engages in a variety of other outreach efforts throughout all stages of development of its regulations in addition to stakeholder meetings and listening sessions, including hearings, roundtables, and advisory boards to obtain information and feedback from industry and consumers. The information and input obtained through these outreach mechanisms are also considered throughout all stages of developing and promulgating the proposed regulation at issue.

Questions for the Record Submitted by Rep. Kyrsten Sinema:

1. It is my understanding that the CFPB is going to begin a formal regulatory process aimed at pay day lending. Is the CFPB coordinating with DOJ, the OCC and the FDIC, regarding the potential interaction between Operation Choke Point and rules intended to regulate pay day lending?

Response:

As it develops its rulemaking proposal, the Consumer Financial Protection Bureau will consult with other Federal agencies, as provided by Section 1022 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[14]

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[13] *See* 5 U.S.C. § 605(b).
[14] *See* 12 U.S.C. § 5512.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Peter King

- **Recently, NCUA proposed a risk-based capital rule for credit unions over $50 million in assets. This rule would impose a Basel-like capital regime on top of the already stringent statutory capital requirements that credit unions must follow.**

  I have heard a number of concerns from credit unions regarding this proposal. In the proposed rule, the Board indicates that if the rule were applied today only a small number of credit unions would be reclassified as undercapitalized and that these credit unions would collectively have to raise $63 million in order to be adequately capitalized. However, industry groups have estimated that credit unions will have to hold an additional $6.7-$7.3 billion in capital in order to keep the same capital cushion as they currently hold.

  Why is there such a large discrepancy between the Board's estimated impact and the impact credit unions believe they will sustain?

Some trade associations have estimated that the implementation costs could run as high as $7 billion, but NCUA estimates the cost as substantially less. The industry's overstated figures are based on a questionable assumption that every federally insured credit union would seek to maintain its current capital cushion above the regulatory minimum.

For example, if a credit union currently has 13 percent net worth, it has a 6 percent cushion between the 7 percent leverage capital requirement and their actual net worth. If the same credit union's risk-based capital ratio became 13 percent under the proposed rule, industry is suggesting that it needs to add another 3.5 percent in its estimate. This estimate suggests that credit union management holds excess capital for other than an informed understanding of the risk in their balance sheet. As a result, the industry group projected the impact to be between $6.3 and $7.3 billion.

In reality, the decision whether to hold a capital cushion and how large that should be is a business decision that each credit union makes. The proposed rule does not require credit unions to maintain any specific capital cushion above the regulatory minimum standard for being well-capitalized. Additionally, the measure of an individual credit union's capital adequacy should not be based upon maintaining a targeted dollar amount above the regulatory minimum. Proper capital adequacy measurement should be much more granular and based on each credit union's strategic plan and risk profile.

Under NCUA's proposed rule, the overwhelming majority of credit unions would experience no change in their assigned prompt corrective action category. Overall, the proposed rule would only apply to federally insured credit unions with assets of $50 million or more—approximately

2,200 out of about 6,600. As a result, the estimated 4,400 federally insured credit unions below $50 million in assets—two-thirds of all credit unions—are not affected by the proposed rule. No small credit union's capital requirement would be affected by the new rule.

Of the 2,200 credit unions subject to the rule as proposed, nearly half would actually see an improvement in their capital levels relative to their risks. Additionally, because the overwhelming majority of these 2,200 credit unions would experience no change in their prompt corrective action category under NCUA's proposed rule, the rule would not require them to raise any additional capital. Under the proposed rule and using December 2013 data, 92 percent of all federally insured credit unions would remain well capitalized, 5 percent of credit unions that are currently undercapitalized would remain so, and only 3 percent of credit unions would see a reduction in their prompt corrective action category because of the proposed rule.

Collectively, only 201 federally insured credit unions comprise the 3 percent affected by the proposed rule. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital—but only if all 201 choose to maintain their balance sheets' current risk exposure. Alternatively, without raising any more capital, these affected credit unions could reduce their risk-weighted assets; or they could choose a combination of these two strategies.

- **Did NCUA conduct an economic analysis of its proposal before putting this rule out for comment?**

As I mentioned earlier, there are 201 federally insured credit unions in the 3 percent affected by the proposed rule. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital (equivalent to 0.8 percent of assets on average), but only if all 201 choose to maintain their balance sheets' current proportional risk exposure as they continue to grow. This amounts to about one year of earnings for the typical credit union. Alternatively, these affected credit unions could reduce their risk-weighted assets to comply with being well-capitalized under the proposal, or choose some strategic combination of the two.

Since the imposition of Prompt Correction Action requirements, NCUA has worked effectively with those credit unions that experience declines in their capital position through the supervision process. Credit unions that decline from well-capitalized to adequately capitalized are only subject to the statutory earning retention requirement, which can be waived as conditions warrant. NCUA regulations do not establish a time table for a credit union to become well-capitalized.

- **Will you consider conducting additional analysis of this proposal's economic impact before issuing a final rule?**

Yes. NCUA plans to carefully review all comments and to continue to analyze scenarios and issues raised. As NCUA works through the 2,052 comments on the proposed rule provided by stakeholders, we will consider the impact of changes to the rule and address any changes we can make to the supervision process to assist credit unions in adjusting to the revised requirements.

- **Would the Board be concerned if credit unions were forced to reserve $7 billion as a result of this proposal?**

The Board is considering the costs associated with implementing the proposed rule. As discussed above, the $7 billion estimate reaches far beyond the capital improvements contemplated in the proposed risk-based capital rule. NCUA estimates that the 201 credit unions that would drop to adequately capitalized or undercapitalized under the proposed rule would need to raise approximately $633 million in additional capital, which represents approximately 12 months of earnings for the affected credit unions, but only if these credit unions choose to maintain their balance sheets' current risk exposure. Alternatively, without raising any more capital, these affected credit unions could reduce their risk-weighted assets; or they could choose a combination of these two strategies.

- **The Board put this rule out for comment earlier this year and provided stakeholders 90 days to submit their views. When the rule is finalized, credit unions will have 18 months to come into compliance.**

  Why did the Board reject industry representatives' request to extend the comment period? Will you consider giving stakeholders more time to comment on this proposal?

The NCUA Board planned on a 90-day comment period to allow more time than the standard comment period of 30 or 60 days. From the time the NCUA Board issued the proposed rule on January 23 until the close of the comment period on May 28, commenters ultimately had 125 days to review the proposed rule. In all, the comment period was NCUA's second longest in the last two decades and provided ample time for stakeholders to review and provide useful comments.

NCUA received 2,052 letters during the comment period on the risk-based capital rule, the most in the agency's history. The volume and depth of the letters we received, some as long as 47 pages indicate a thoughtful and considered review of all relevant issues. Before finalizing our revised rule on risk-based capital, we plan to carefully analyze and evaluate every comment received.

- **How do you respond to the concerns that credit unions will be asked to implement this new rule in 18 months' time, but small banks will have been afforded nearly nine years to implement Basel III from the time it was first proposed to when it goes into effect in 2019?**

The NCUA Board is committed to re-evaluating the amount of time needed before the final rule goes into effect and has indicated an open mind about extending the implementation period based on the comments received. It will take time for the affected credit unions to amend their risk polices and adjust their balance sheet strategies to comply with the revised regulation. During that same time, NCUA will also need to make major data system changes to accommodate the final risk-based capital rule changes. NCUA will look closely at the impact of implementation timeframes as part of the final rulemaking.

- **Do you have any concerns that credit unions may not be able to raise enough capital quickly enough to maintain the capital buffers under which they currently operate?**

No. First, there is no requirement for a credit union to maintain a buffer above the required regulatory minimum. Most complex credit unions have already accounted for at least some of the additional risk in their balance sheets with additional reserves. The additional capital required equates to about 12 months of average earnings, and some credit unions will choose to reduce their risk profiles.

- **Will you consider giving credit unions more time to come into compliance with this regulation after it is finalized? If not, why not?**

Yes. We continue to analyze implementation capabilities within the credit union system. As part of our review of comments and financial analysis of impact, we will evaluate alternative implementation timelines.

- **Why is the Board proposing a risk-based capital rule that includes features that are more stringent than the requirements on FDIC-insured banks, when the National Credit Union Share Insurance Fund is strong and natural person credit unions are well-capitalized?**

To comply with the Federal Credit Union Act, NCUA is required to update credit unions' risk-based capital standards as financial regulatory capital standards evolve and to be comparable with other federal financial agencies. However, the law also requires NCUA to consider "all material risks" to federally insured credit unions, in contrast to requirements for banks. So while the new Basel III capital accord focuses mainly on credit risk, NCUA's capital standard, to comply with the Federal Credit Union Act, must also account for relevant risks including interest rate and concentration risks. While the proposed rule in some places has a higher risk weight than banks, in other places the risk weight is lower, as is the case with the risk weighting on consumer loans.

The stakeholder feedback received during the comment period will help to inform the NCUA Board's determination of the most appropriate risk weight for each asset type.

- **Some of the proposal's risk weights would be considerably higher than those applied to community banks under the Basel system even though credit unions are more risk averse.**

  How did the Board determine the risk-weighting under this proposal?

While striving for overall comparability with the FDIC's rule, NCUA has proposed several different risk weights, consistent with the law, such as a lower weight of 75 percent for credit unions' consumer loans in comparison to the banking system's risk weight of 100 percent. NCUA also proposed retaining the tiered risk-weight approach from our existing rule to account for higher concentrations in member business loans and mortgage loans. A 2012 report by the Government Accountability Office specifically recommended NCUA address such concentration

risk. Similarly, NCUA proposed maintaining tiered risk weights for longer-term investments in order to account for interest rate risk.

Please be assured, as part of the rulemaking process, the NCUA Board will carefully consider the comments received when determining how best to calibrate the final risk weights, including any comments received about the risk weights for real estate loans, agricultural loans, and member business loans. The stakeholder feedback will help to inform us in determining the most appropriate risk weight for each asset type. Further, when issuing the final rule, we will provide further clarity in response to comments as to how NCUA calculated certain risk weights and why those risk weights may, in some instances, differ from the risk weights for federally insured banks.

- **Why does the proposed rule apply higher risk weights for mortgage loans and business loans for credit unions that have higher concentrations of these loans? Is there a comparable requirement under the Basel III rules for small banks?**

The Federal Credit Union Act specifically requires NCUA to consider any material risks in developing a risk-based capital requirement for credit unions, including concentration risk. The Government Accountability Office in reports about NCUA and the NCUA Inspector General in recent material loss reviews have both cited concentration risk as a material risk. As a result, NCUA needed to address these risks in the proposed risk-based capital rule. Basel III represents the bank capital standard, but as noted above it generally does not address concentration and interest rate risks.

- **Why has the NCUA chosen to account for interest rate risk and concentration risk in a capital system as opposed to through supervision and examination which is how it is done now for credit unions and community banks? Is the examination and supervision process currently in place now broken?**

While the new Basel III capital accord focuses mainly on credit risk, NCUA's capital standard, to comply with the Federal Credit Union Act, must also account for any material risks, including interest rate and concentration risks. NCUA maintains strong safety and soundness oversight and appropriate regulation scaled to minimize regulatory burden. However, additional capital serves as a risk-mitigation measure and a deterrent to excessive risk taking, while also providing an individual credit union the discretion to determine the business model that best fits its membership base. Addressing concentration risk through risk-based capital provides flexibility while encouraging appropriate market discipline with our supervised institutions.

Critics contend that because most U.S. credit unions survived the crisis with relatively strong capital, this rule is unnecessary. However, that survival required an infusion of $20 billion from NCUA's Central Liquidity Facility and $6 billion from NCUA's line of credit at the U.S. Treasury. Even with that extraordinary level of assistance, 102 credit unions failed during the economic downturn. Although many of those failed credit unions appeared to have high net worth ratios, they actually lacked sufficient capital to protect against the risks on their balance sheets. Those failures cost the National Credit Union Share Insurance Fund three-quarters of a

billion dollars. This cost had to be paid by all surviving credit unions, which as cooperatives, are required by law to share in the losses on a proportional basis.

Had NCUA's proposed risk-based capital rule been in place before the crisis, the $750 million in losses would have been substantially reduced, and several credit union failures could have been avoided.

- **Do you have concerns that these risk weightings could hinder credit union lending to home owners and small businesses?**

The current regulatory framework for credit unions provides many options for an informed management team to continue providing or even increasing service to its members. The current rule has higher risk weights for real estate loans and for member business loans. The current rule also does not curtail either real estate lending or member business lending.

Most credit unions would continue to be well-capitalized under the proposed rule. Only three percent of federally insured credit unions need additional capital to attain adequate levels of risk-based capital. Additionally, many credit unions engaging in these types of lending already carry more than the required leverage ratio in capital.

The relatively small number of credit unions with large concentrations of real estate or member business loans currently pose a risk and potential cost to other institutions through the cooperative credit union system. In other words, these institutions may become a drag across all institutions in small amounts that could more broadly hinder the industry's ability to lend to its members. The proposed risk-based capital rule merely requires institutions assuming greater levels of risk to account for more of it on their own balance sheets instead of transferring costs to other well-capitalized credit unions that are more diversified and less risky. The improved capital standard helps ensure long-term sustainability across the industry. Long-term viability is the most effective means of assuring members have choices in their borrowing decisions.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Ed Royce

- **Related to the proposed risk-based capital rule for credit unions over $50 million in assets, how did the NCUA determine the risk-weighting under this proposal?**

While striving for overall comparability with the Federal Deposit Insurance Corporation's rule, NCUA proposed several different risk weights, consistent with the law, such as a lower weight of 75 percent for credit unions' consumer loans in comparison to the banking system's risk weight of 100 percent. NCUA also proposed retaining the tiered risk-weight approach from our existing rule to account for higher concentrations in member business loans and real estate loans. A 2012 report by the Government Accountability Office specifically recommended NCUA address such concentration risk. Similarly, NCUA proposed maintaining tiered risk weights for longer-term investments in order to account for interest rate risk.

As part of the rulemaking process, the NCUA Board will carefully consider the comments received when determining how best to calibrate the final risk weights, including any comments received about the risk weights for real estate loans, agricultural loans, and member business loans. The stakeholder feedback will help to inform NCUA in determining the most appropriate risk weight for each asset type. Further, when issuing the final rule, NCUA will provide additional clarity in response to comments as to how the agency calculated certain risk weights and why those risk weights may, in some instances, differ from the risk weights for federally insured banks.

- **Why does the proposed rule apply higher risk weights for mortgage loans and business loans at credit unions with higher concentrations of these loans? Do the Basel III rules applying to small banks include a comparable requirement?**

The proposed risk weights reflect material risks that must be accounted for in a risk-based capital system for credit unions. NCUA's existing risk-based net worth standard has higher risk weights for higher concentrations of mortgage loans and member business loans. The Federal Deposit Insurance Act does not include the same requirements for banks.

Specifically, section 216(d) of the Federal Credit Union Act requires NCUA to formulate a risk-based net worth requirement to apply to complex credit unions. The subsection also mandates that the risk-based net worth requirement must "take account of any material risks against which the net worth ratio required for [a federally] insured credit union to be adequately capitalized may not provide adequate protection." This includes interest rate risk and concentration risk.

Congress indicated that the design of the risk-based net worth requirement "should reflect a seasoned judgment about the actual risks involved." Congress also encouraged NCUA to "consider whether the six percent requirement provides adequate protection against interest-rate

risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks."

- **Have you evaluated the impact of these new capital rules in rural areas, where credit unions often have high concentrations of agricultural and business loans? If so, what were the findings?**

In evaluating the impact of the proposed rules, regardless of the location of the credit union NCUA determined the number of credit unions with higher-risk balance sheets that could experience a decline in their prompt corrective action classification. We then conducted further analysis including extensive "what if" analysis of changes in risk-weights and concentration risk thresholds. Finally, during the comment period NCUA provided credit unions with an online tool to determine their proposed risk-based capital measure to improve understanding of the proposal.

Collectively, there are 201 federally insured credit unions affected by the proposed rule; some of these credit unions operate in rural areas. NCUA estimates these credit unions would need to add a collective total of about $633 million in additional capital (equivalent to 0.8 percent of assets on average), but only if all 201 choose to maintain their balance sheets' current risk exposure. This amounts to about one year of earnings for the typical credit union. Alternatively, these affected credit unions could reduce their risk-weighted assets to comply with being well capitalized under the proposal, or choose some strategic combination of the two.

Additionally, many credit unions in rural areas would also be eligible for a low-income designation, which would provide an opportunity to raise supplemental capital if needed.

- **You stated at the hearing that these risk-weightings take into consideration the unique characteristics of credit unions? How is this done?**

We adjusted the risk weightings based on our supervisory and loss experiences in the credit union system, as well as historical credit union performance. For example, because of credit unions' historical performance with consumer loans, a lower weight of 75 percent was used in comparison to the banking system's risk weight of 100 percent. Additionally, loss experiences indicate that some federally insured credit unions that have failed had mismanaged real estate portfolio and member business loan concentrations. The proposed rule addresses the concentration risk in these areas as required by the Federal Credit Union Act.

- **Related to small business lending (please provide reasoning if you believe the NCUA does not have the authority to provide regulatory relief), does the NCUA have the authority to allow loans on a 1-4 family dwelling to be excluded from loans counted toward the MBL statutory cap, even if the borrower does not use the dwelling as its primary dwelling, if the dwelling is used as such by any member of the credit union? (For example, Member X obtains a loan on a 1-4 family dwelling and rents it to another member who uses the dwelling as a primary residence. That loan should not count toward the cap.)**

NCUA lacks the authority to allow loans on a 1-to-4 family dwelling to be excluded from the member business lending cap if the borrower does not use the dwelling as a primary residence, even if the dwelling is used as a primary residence by another credit union member. The Federal Credit Union Act provides that an extension of credit that is fully secured by a lien on a 1-to-4 family dwelling that is the primary residence of a member is exempt from the definition of member business loan. NCUA interprets this to mean the dwelling is the primary residence of the borrower. Legislative history of this provision supports this interpretation.

- **Does the NCUA have the authority to allow credit unions, which have a significant proportion of their loans in MBLs for the last five years, to qualify for an exemption from the cap under the "history of primarily making MBLs" provision of the Federal Credit Union Act?**

NCUA has the statutory authority to define if a credit union, which has had a significant proportion of its portfolio in member business loans for the last five years, has a history of primarily making member business loans and would therefore qualify for an exemption from the statutory cap. However, the current regulation defines credit unions that have a history of primarily making member business loans as credit unions that have either 25 percent of their outstanding loans in member business loans or member business loans comprise the largest portion of their loan portfolios, as evidenced by any Call Report or other document filed between 1995 and 1998. The Call Report years noted in the definition reflect the time period leading up to the enactment of the Credit Union Membership Access Act of 1998, in which the "history of primarily making" standard was first included. Based on our interpretation of the 1998 law, the current definition focuses on a credit union's historical behavior during the years leading up to the enactment of the Credit Union Membership Access Act, and seems to make the most logical sense from a timing perspective.

- **Does the NCUA have the authority to eliminate requirements related to construction and development loan limits, and the personal guarantee of a borrower, which are not required under the Federal Credit Union Act?**

Yes, NCUA does have the authority to eliminate regulatory provisions that are not required by statute, including requirements relating to construction and development loans and the personal guarantee of the borrower requirement.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Robert Pittenger

- **Why has NCUA increased its overall budget size over the past seven years? During the past several years other agencies have had to tighten their belts, and it seems odd to see an agency not related to defense grow at six percent or more some years. Would NCUA please provide the committee with a detailed financial analysis supporting these increases over the seven-year period?**

In response to the recent financial crisis, NCUA's budgets over the past several years have increased. The NCUA Board made several responsible policy changes, each of which affected NCUA's budget needs.

There were two significant policy changes impacting the budget. The first eliminated the 18-month exam cycle and replacing it with an annual exam cycle with CAMEL code 3, 4, and 5 credit unions receiving even more frequent supervisory attention. The second had NCUA conduct annual insurance exams for state-chartered credit unions with assets over $250 million in assets rather than the previous $500 million asset threshold.

These new policies responded to material loss reviews by the independent NCUA Inspector General. The Inspector General's postmortem analyses of credit union failures found serious threats had developed at credit unions between examinations under the previous 18-month exam cycle. Failures could have been prevented and losses would have been significantly reduced with timelier onsite visits to detect and address material issues earlier.

These new policies required increased examiner hours, an expanded workforce needed to execute the necessary supervision tasks, and higher travel costs. However, the policy decisions worked as intended. NCUA minimized credit union failures and associated losses to the National Credit Union Share Insurance Fund.

By taking these actions, NCUA protected surviving credit unions and their members from paying for higher losses. The total 2009–2012 budget increase amount of $59.0 million prevented up to $1.1 billion in further losses credit unions would have had to pay for credit unions that were on the brink of failure.

The share of assets held in credit unions with CAMEL code ratings of 3, 4 or 5 increased nearly fourfold from historical norms during the height of the crisis. At the same time, the need to provide increased supervision of troubled credit unions increased NCUA budgets and outlays. Specifically, during the crisis the share of natural-person credit union assets associated with troubled CAMEL code 4 and 5 ratings more than quadrupled over historical norms, to a high point of more than 5 percent of industry assets—more than $50 billion held in troubled credit unions.

Such combined failures could have overwhelmed the Share Insurance Fund and devastated the entire industry had NCUA not immediately dealt with the problems. NCUA enhanced supervision, while struggling credit unions stepped up and worked hard to improve their operating efficiencies. As a result of collective action by both the industry and regulators, coupled with a steady economic recovery, overall credit union metrics are improving today and the entire system is more resilient.

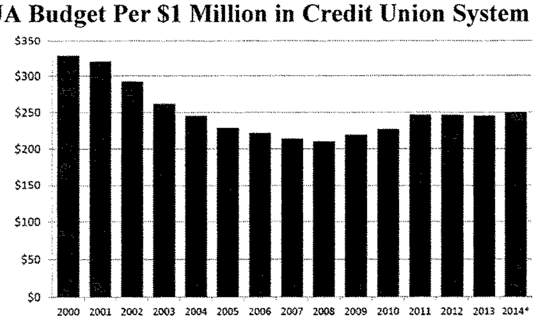
Continued vigilance and supervision are necessary to help return as many troubled credit unions to higher CAMEL ratings as possible, and prevent future losses to the Share Insurance Fund. NCUA's 2014 budget and those of recent years were a necessary means to accomplish the agency's statutory mission and maintain consumer confidence in the credit union system.

NCUA's budgets reflect core strategic goals which are consistent year-over-year in the agency's Strategic Plan. This plan focuses on maintaining a healthy credit union system and Share Insurance Fund to accomplish the agency's statutory mission and ensure continued consumer confidence in the credit union system.

During the expansionary economic cycle that occurred just before the recent recession, NCUA staff had decreased, even as the credit unions were growing in both size and complexity. Additionally, the NCUA budget remained essentially flat from 2001 to 2007. As the recent recession began and the number of troubled credit unions grew alarmingly, NCUA increased its budget. It is worth noting that any budget savings credit unions derived from those pre-recessionary years were dwarfed by more than $900 million in actual natural-person credit union losses that surviving federally insured credit unions paid for through the Share Insurance Fund from 2008 to 2012.

Looked at another way, for the last three years NCUA's budget expressed as a share of industry assets has remained essentially flat at just under $250 per $1 million of federally insured credit union assets. This ratio fell dramatically from $330 per $1 million in 2000 to a low point of $210 per $1 million. The chart below illustrates this point more clearly.

NCUA Budget Per $1 Million in Credit Union System Assets



Source: NCUA Annual Budgets, Call Reports
FICU assets are as of end of previous year.
* 2014 assets are estimated

Because of the dire situation, and similar to FDIC and other regulators of financial institutions, NCUA was forced to increase its budget to deal with these critical issues. Financial regulatory budgets have tended to be counter-cyclical. That is, when the economic cycle turned down, financial regulators staffed up. These increases, although necessary, also compounded the financial burden on many credit unions as they were facing mounting charge-off losses and weak earnings. So, rather than implementing immediate large budget increases similar to actions taken by other financial institutions regulators (some over 80 percent per year), NCUA strategically spread out necessary budget increases over multiple years. This approach steadily rebuilt NCUA resources at a measured pace to help minimize the funding burden on credit unions during the recession.

In addition, the NCUA Board has taken the approach that the budget is not intended to be strictly counter to economic cycles, thus only rising when crises occur. The Board is focused now on building optimum capacity when the economy and the industry is performing relatively well, in order to ensure long-term safety and soundness, and to keep pace with growing credit union complexity. By contrast, the counter-cyclical approach to reducing the budget during times of improved credit union performance would be like to laying off firefighters between fires. The NCUA Board's approach is intended to ensure the necessary resources are in place before the next crisis, which puts NCUA in the best position to reduce the risk of major losses in the future.

- **While I am back in the district, I still hear a number of complaints about the examination process. Whether this is a community bank or credit union—both believe the examiners are out of touch and are only there to do harm. Would you please explain the NCUA examination appeals process? Also, why do credit unions feel the agency's appeals process is inadequate and how many credit unions have been able to successfully appeal examiner decisions in the last year, last five years, and last seven years? Finally, how does the ombudsman function in terms of the examination process—especially in regards to representing the interests of credit unions? Would you please explain the NCUA examination appeals process?**

NCUA has a multi-level appeals process consisting of informal and formal appeals avenues. Because we believe many concerns can be efficiently and effectively addressed with additional communication, the purpose of our appeals structure is to encourage immediate dialogue with the individuals most closely associated with local credit unions. We encourage credit unions to discuss concerns openly with their examiners and supervisory examiners, and most concerns are successfully handled in this way.

NCUA also realizes the importance of a formalized, independent appeals process for those instances where credit unions do not believe they are being adequately heard. Credit unions may therefore appeal formally in writing to their regional director within 30 days of receiving final reports. Upon receipt of an appeal, a regional director will conduct a review of the facts and respond formally in writing.

Additionally, Congress enacted the Riegle Community Development and Regulatory Improvement Act (Riegle Act) in 1994.[1] Section 309 of the Riegle Act required, among other

[1] See Public Law 103-325, §309(a), 108 Stat. 2160.

things, that NCUA and the federal banking agencies each establish an independent appellate process to review material supervisory determinations. Specifically, the Riegle Act required the NCUA to establish "an independent intra-agency review process for material supervisory determinations, appoint an Ombudsman, and develop an alternative dispute resolution program." In response, the NCUA Board established a Supervisory Review Committee, created an Ombudsman position, and issued an alternative dispute resolution program policy statement.[2]

The Supervisory Review Committee is comprised of three independent members of the NCUA's senior staff, as appointed by the Chairman. The committee reconsiders and makes recommendations on material supervisory determinations. Supervisory determinations are limited to:

- Appeals of composite CAMEL ratings of 3, 4, and 5 and all component ratings of those composite ratings;
- The adequacy of Allowance for Loan and Lease Loss funding determinations; and
- Loan classifications on loans that are significant as determined by the appealing credit union.

Credit unions may appeal Supervisory Review Committee decisions to the NCUA Board within 30 days of receiving the Supervisory Review Committee's decision.

To protect credit unions from reprisals, NCUA has a zero-tolerance retaliation policy. Examiners may not take action against a credit union for using any formal or informal appeal channel. If a supervisor discovers an examiner retaliated with unreasonable action against a credit union, that examiner will face disciplinary action. In addition to the appeal information outlined above, credit unions are provided contact information for NCUA's Office of General Counsel, Office of Examination and Insurance, and Office of the Inspector General as a part of every examination. Finally, NCUA has continuously maintained a zero-tolerance policy pertaining to retaliation.

In 2012, after conducting nationwide Listening Sessions with stakeholders NCUA took additional steps to enhance credit union management access to informal appeals process. We made changes to the examination report to include direct access information for the examiner-in-charge, the field examiner, and the regional office for each credit union. We also placed field manager and examiner-in-charge contact information on the credit union online portal for each credit union. In addition, we changed the examination cover page to outline the steps and all options for the informal and formal appeals process, and incorporated those steps and contacts into the examination report cover documents.

- **Also, why do credit unions feel the agency's appeals process is inadequate and how many credit unions have been able to successfully appeal examiner decisions in the last year, last five years, and last seven years?**

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[2] See 61 FR 11433-34 (March 20, 1996). Section 309(e) of the Riegle Act envisioned the use of alternative dispute resolution methods to resolve claims against insured credit unions for which NCUA has been appointed conservator or liquidating agent; actions taken by NCUA in its capacity as conservator or liquidating agent; and any other issue for which the NCUA Board determines that alternative dispute resolution would be appropriate. See NCUA Rules and Regulations at 12 CFR §709.8(c).

While we do not track the number of informal appeals resolved with credit unions, we know that very few are not able to be resolved at the lowest levels.

Frequently, we receive indirect information that credit unions fail to appeal an examination issue because they fear retaliation. However, there is no evidence of retaliation, despite our continued outreach during the last several years to obtain more information about such concerns. We maintain a very aggressive communication expectation with our examiners and field supervisors. Our informal conflict management process encourages immediate communication and resolution at the earliest possible time and with the individuals with the greatest working relationship and institutional knowledge (the examiner-in-charge and field supervisor). We believe the vast majority of issues and concerns raised are resolved early in the process and before they become formal appeals.

During the last year, NCUA's Supervisory Review Committee has considered no appeals. For the last five years between 2010 and 2014, there have been seven appeals, and for the last seven years between 2008 and 2014, there have been eight appeals. None of the exam appeals have been decided in favor of the credit union. The years are based on the dates the examination appeal was received, not when the final decision was rendered.

- **Finally, how does the ombudsman function in terms of the examination process—especially in regards to representing the interests of credit unions?**

In a Board Action Memorandum approved by the NCUA Board on March 13, 1995, the Board established an Ombudsman position. In the memorandum, the Board stated that the Ombudsman position would be held by an existing NCUA employee appointed by the Chairman; the functions of the position would be collateral to the appointee's current duties; and the Ombudsman would report to the Board. In addition, the Board authorized the appointee to act independently of NCUA program functions and to have access to agency records. The Board further authorized the Ombudsman to keep confidential any information and material obtained as a result of investigating complaints.

NCUA's Ombudsman investigates complaints and recommends solutions. These complaints must relate to regulatory issues that cannot be resolved at the operationally at the regional level. The Ombudsman assists in resolving problems by helping the complainant to define options and by recommending actions to the parties involved, but the Ombudsman cannot at any time decide on matters in dispute or advocate the position of the complainant, NCUA or other parties.

The Ombudsman does not handle any matter:

- subject to formal review as set forth in NCUA regulations or NCUA interpretative rulings and policy statements;
- involving an enforcement action where a notice of charges has been filed;
- in litigation;
- involving a conservatorship or liquidation; or
- within the Inspector General's jurisdiction.

The Ombudsman will make recommendations to appropriate agency officials for systemic changes to deal with recurring problems revealed through investigations.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Mick Mulvaney

- **Mr. McKenna, I understand that the National Credit Union Administration (NCUA) releases audits, financial statements and data regarding its operating budget, the National Credit Union Share Insurance Fund (NCUSIF), Central Liquidity Facility (CLF), and the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). These reports only show aggregated figures instead of line-by-line or other breakdowns of expenditures. In the interest of budget transparency, I am curious to know why NCUA releases only aggregate figures and not more specific, line by line details regarding these expenses? Would you please share a more detailed breakdown of the NCUA operating budget and above-referenced accounts with this Committee?**

NCUA formulates the agency's Operating Budget using zero-based budgeting techniques in which every expense must be justified each year. The budget is formulated from input provided by NCUA program offices, vetted through the Executive Director, and presented to the NCUA Board for approval annually at the November open Board meeting. The Operating Budget is subsequently adjusted at the open Board meeting each July based on a mid-year financial analysis. Based on this analysis, funds may be returned to the credit unions in the form of reduced credit union assessments the following year.

A portion of the Operating Budget is reimbursed from the National Credit Union Share Insurance Fund through the Overhead Transfer Rate. The share of the Operating Budget paid for by the Share Insurance Fund is also presented to the Board for approval at the open November Board meeting.

The Temporary Corporate Credit Union Stabilization Fund follows a similar budget formulation and presentation process with its annual budget presented to the Board at the December open Board meeting.

NCUA is committed to budget transparency. The annual budget, mid-year adjustment, and Overhead Transfer Rate are formally presented to the Board by Board Action Memorandums. The memorandums, as well as transcripts and videos of the open Board meetings, are available on at www.ncua.gov. In addition, NCUA posts NCUA budget and supplemental material, providing additional budget detail.

All of NCUA's funds are included in the President's Budget. The budget for the Central Liquidity Fund Budget is presented in the President's Budget as part of the annual discretionary budget.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Scott Garrett

- **I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations or statutory language that restrict FSOC voting members (the Agencies' principals) from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NPD) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD. Do the Agencies support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on a NPD.**

Your first question asked if are there rules, regulations or statutory language that restrict FSOC voting members from meeting with firms that are under consideration for a non-bank systemically important financial institution designation. There are no such restrictions. Member agencies are allowed to make their own determinations about meetings. Many member agencies have chosen to limit discussions with firms under Stage 3 consideration on topics related to designation. The purpose of these limitations is to ensure member agencies are receiving the same set of information. NCUA has followed this process.

The designation process gives firms the opportunity for a hearing after the Notice of Proposed Designation and prior to a vote on designation. This timing is appropriate because after the Notice of Proposed Designation the firm is provided with the FSOC brief and therefore has an opportunity to discuss and rebut key arguments.

Finally, you asked whether the Agencies would support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity. NCUA believes the process is working effectively. A firm under consideration recently requested the opportunity to meet with the voting members. In order to maintain consistency with the process laid out in the rule, they decided to hold a joint meeting between the firm and the FSOC Deputies. This meeting provided the firm with an opportunity to make their key arguments in person.

House Financial Services Committee
Hearing on Regulation and Supervision of Financial Institutions
April 8, 2014

Questions for Michael J. McKenna, NCUA General Counsel, from Congressman Michael Fitzpatrick

- **I hear a lot of concerns from credit unions about the NCUA budget. In 2014, the NCUA proposed a 6.7% budget increase over last year, and that this is at least the fifth year in a row that the agency's budget has increased over 5%. This seems to be contrary to many areas in government where agencies are tightening their belts and facing cuts. It is my understanding that a majority of the budget is funded through assessments on credit unions, meaning that these budget increases are taking more money from institutions that might otherwise use it to make an auto loan or a home loan to a family who needs it.**

  In order to better understand the agency's budget and the need for these increases, please share with us line-by-line or other further detail breakdowns of the agency's expenditures for both 2013 and 2014, including the operating budget and any funds under the agency's control. Is this detailed information shared with credit unions, either at the time when the budget is released, or at the end of the year. If not, why not? Wouldn't great transparency be a good thing when the agency is asking for increases?

NCUA operates on a calendar-year basis for its budget and collects fees from federal credit unions with assets over $1 million to fund the agency's operations. The NCUA Board sets these rates annually in an open meeting. NCUA uses the operating fees to pay the costs of regulating federal credit unions. For 2014, the Board approved an 18.4 percent decrease in the fee rate.

The NCUA budget fulfills two statutory responsibilities. First, it protects the safety and soundness of the credit union system. Second, it seeks comparability in pay and benefits for NCUA employees compared with other federal financial services regulators. To ensure we have the resources needed to protect safety and soundness, we must follow a fundamental principle: As credit union assets grow, the NCUA budget needs to grow as well. In particular, as credit unions grow larger and more complex, exam hours to supervise credit unions will increase. In response to the 2008 financial crisis, the NCUA budget increased commensurately with credit union asset growth. That said the NCUA budget as a share of credit union assets is lower now than in the year 2000.

NCUA takes the stewardship of its budget very seriously. The 2014 budget reflects the demands of a $1.1 trillion industry, a changing regulatory environment, and our determination to fulfill NCUA's mission while making prudent use of available resources. NCUA continues to properly compensate staff who keep NCUA running and keep credit unions safe and sound. We also need to achieve pay comparability with all federal financial agencies, so we can attract and retain qualified employees. While NCUA employees did not receive a base salary increase for the past

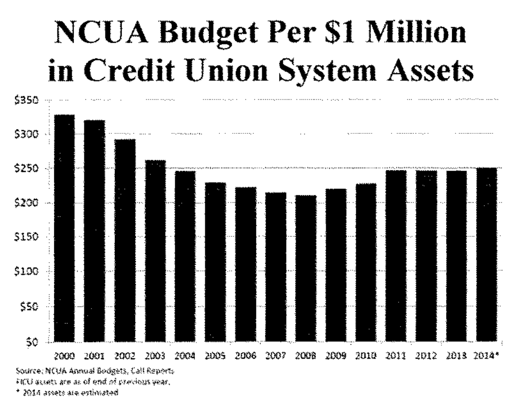
two or three years, the 2014 budget reflects the compensation negotiated in NCUA's current collective bargaining agreement.

The NCUA Board approves the annual operating fund budget during the November open Board meeting each year. The Board revisits the budget in July when it makes adjustments based on actual year-to-date spending. Funds are often returned to the credit unions the following year in the form of reduced credit union assessments.

All open Board meeting videos and transcripts are available at www.ncua.gov, including supplemental material about the NCUA Budget to provide greater transparency. Below is a summary of the 2013 budget, actual 2013 spending, and the 2014 Budget:

Category	2013 Budget	2013 Actual	2014 Budget
Employee Pay and Benefits	$ 183,601,304	$ 177,728,300	$ 194,632,214
Travel	27,861,782	27,163,125	28,514,578
Rent, Communications & Utilities	5,296,397	4,870,829	5,615,191
Administrative	13,610,236	11,712,633	15,393,236
Contracted Services	21,017,372	20,978,025	24,135,077
Total	$ 251,387,091	$ 242,452,912	$ 268,290,296

Although the NCUA budget increased by 6.7 percent in 2014 over the prior year, for the last three years NCUA's budget expressed as a share of industry assets has remained essentially flat at just under $250 per $1 million of federally insured credit union assets. This ratio fell dramatically from $330 per $1 million in 2000 to a low point of $210 per $1 million. The chart below illustrates this point more clearly.



In addition, NCUA posts monthly highlights of its Operating Fund on its website. NCUA is committed to maintaining transparency in its budget and spending to remaining an effective steward of its resources.

Response to questions from the Honorable Scott Garrett by the Federal Deposit Insurance Corporation

Q1: (FRB, CFPB, OCC, FDIC and NCUA regarding the nonbank SIFI designation process)

I'm interested in the Agencies' positions regarding the non-bank SIFI designation process. Specifically, are there rules, regulations, or statutory language that restrict FSOC voting members (the Agencies' principals) from meeting with firms that are under consideration for non-bank SIFI designation? Does the firm under consideration meet with the FSOC voting members, including Chair Yellen, Comptroller Curry, Chairman Gruenberg, and Chairman Matz before voting on a Notice of Proposed Designation (NPD) or is it after such a vote? It's my understanding that the process, thus far, has not included an opportunity for a firm to make their case that they are not systemic to the FSOC voting members prior to the FSOC voting to designate a firm via a NPD. Do the Agencies support the opportunity for a firm to meet with FSOC voting members prior to a NPD vote, if the firm requests such opportunity? If not, please explain why any of the Agencies opposes the opportunity for a firm to meet with Agency principals prior to their vote on a NPD.

A1: The nonbank SIFI designation Rule and Guidance and the Dodd-Frank Act do not specifically address the issue of Council members meeting with a company prior to a vote for a proposed designation. The procedures outlined in the Rule and Guidance, adopted after two rounds of notice and public comment, ensure that all companies analyzed by the Council receive consistent treatment. In addition, the Council's hearing procedures provide companies considered for SIFI designation with due process rights beyond what is prescribed in the Dodd-Frank Act.

In the months prior to consideration of any vote for proposed designation, member agency staff conduct extensive analysis of the company and the capacity of the financial markets to successfully weather the company's material distress or failure. This research draws from public sources and from information provided by the company's regulators and the company itself. During this time, a company may have extensive contact with Council staff and an analytical team comprised of staff from various Council member agencies. Although not required by the statute, the Council welcomes meetings between company representatives and members of the analytical team to discuss details of the company's operations and financing and to hear the company's views. This research informs the development of the analytical memoranda the Council members use during deliberations.

In addition to providing opportunities for extensive contact between a company being evaluated and the research staff, the Council has adopted hearing procedures, clarified in response to industry comment, to ensure that any company that wishes to contest a proposed designation can fully and fairly present its arguments to the Council. Any company that receives a proposed designation may request a written or oral hearing before the Council, and there is a presumption that a timely request for an oral hearing with be granted. The Council provides any company that has been proposed for designation with a document explaining the basis of the proposed designation to use when crafting its documentary evidence and exhibits for presentation to the Council. At any oral hearing, company representatives may present oral testimony or argument

and respond to questions. After an oral hearing, a company may submit additional written materials for seven days to supplement the material that was presented.

Close adherence to the policies and procedures the Council has developed, with public and industry feedback, ensures that each company under consideration gets consistent treatment and that there is robust exchange of information throughout the designation process.

Q2 addressed to the FRB

Response to questions from the Honorable Peter King by the Federal Deposit Insurance Corporation

Q1: (FDIC, OCC and FRB on their proposed Liquidity Coverage Ratio rule)

I am glad that representatives from the FDIC, OCC, and the Fed are all here today, because I would like you all to comment on the Liquidity Coverage Ratio proposal your agencies put out to comply with the Basel Committee's requirements. I am particularly concerned about how the treatment of municipal securities and deposits will affect municipalities – including New York City and communities affected by Superstorm Sandy – which depend heavily on muni bonds to fund critical infrastructure. Can you explain why your agencies did not grant municipal bonds status as "High Quality Liquid Assets" (HQLA), despite the Basel Committee's recommendation to do so? I understand that under your proposal corporate bonds and even sovereign debt were given HQLA treatment. Why is the debt of small nations whose sovereign securities are illiquid or even distressed, are treated as higher quality than securities from our own states and districts? Can you explain that decision?

A1: The agencies have received many comments on this issue. As we develop a final rule, we will carefully consider the comment letters and data regarding the liquidity of municipal securities and their suitability for inclusion as HQLA.

In developing the proposed rule, the banking agencies determined that there are many sound reasons why, absent an LCR, most banks currently do not include municipal securities in their liquidity pool. Due partly to the tax treatment of municipal securities, the investor base for municipal securities is skewed much more toward individual rather than institutional investors, transactions sizes are much smaller, and municipal securities are rarely used in repurchase transactions. Given this, as a general rule, most municipal securities lack a sufficiently deep and active secondary market and, as such, a firm would have difficulty selling or otherwise monetizing significant amounts of municipal securities in a liquidity crisis without realizing meaningful losses or causing significant dislocation in the municipal bond markets. This does not mean that firms are prohibited or in any way discouraged from investing in municipal securities.

It is important to note that in the proposed rule, not all corporate bonds were accorded HQLA treatment. Only corporate debt that is determined to be liquid and readily marketable, investment grade, and that is issued by an entity whose obligations have a proven record as a reliable source of liquidity in repo or sales markets during stressed conditions is eligible for HQLA. Even then, in the proposals such corporate debt was limited to level 2B HQLA, which represents no more than 15 percent of a covered company's HQLA Amount.

Foreign sovereign debt is eligible to be included in HQLA only in limited circumstances. The debt of small nations whose sovereign securities are illiquid or even distressed is not eligible for inclusion in HQLA.

The proposed rule would allow unconditionally guaranteed foreign sovereign debt to be included in level 1 HQLA if it is assigned a 0 percent risk weight under the banking agencies' capital

regulations, is liquid and readily marketable, and is issued by an entity whose obligations have a proven record as a reliable source of liquidity in repo or sales markets during stressed conditions is eligible for HQLA. Foreign sovereigns that have defaulted or whose securities are distressed would not be eligible for such treatment (*see, e.g.*, 12 CFR §324.32).

Foreign sovereign debt that is not assigned a 0 percent risk weighting but that is (i) unconditionally guaranteed by the sovereign, (ii) issued in the currency of the sovereign, and (iii) liquid and readily marketable may be used by a covered company for the limited purpose of offsetting a covered company's net cash outflows in the jurisdiction of the sovereign entity.

Q2: Your agencies' LCR proposal also treats municipal deposits as secured transactions under the rule which means they would be subject to a 100 percent unwind for purposes of the ratio calculation. I am concerned this will hamper municipalities' ability to seek the banking services they need to make pay-roll and fund day-to-day activities. Can you comment on why these deposits were treated as secured transactions under the proposal?

A2: The agencies have received many comments on this issue expressing similar concerns. After reviewing these comments, we recognize that the treatment of secured municipal deposits is unclear in the proposed rule. We will carefully consider the comments we have received on this issue as we develop a final rule.

Q3 and 4 addressed to the NCUA

Response to questions from the Honorable Carolyn Maloney
by the Federal Deposit Insurance Corporation

Q1: (FRB, FDIC)

In the letter that I, and 16 other Democrats, sent to the regulators on February 12, 2014, we stated that the right to vote on removing an investment manager in traditional, creditor-protective circumstances such as a material breach of contract should not, by itself, trigger an "ownership interest" under the Volcker Rule.

The industry has requested clarification on the scope of the voting rights prong of the "ownership interest" definition in several letters to the regulators as well.

Despite the considerable time that the regulators devoted to the CLO issue, neither the Fed's statement nor the regulators' joint letter to Chairman Hensarling mentioned this voting rights issue.

Do the agencies plan to clarify whether such traditional, creditor-protective voting rights would automatically trigger an "ownership interest" under the Volcker Rule? If so, when do the regulators plan on issuing this clarification?

A1: With respect to the CLO issues raised by industry, the agencies have carefully reviewed comments and data received from the banking and financial services industry and other interested parties. Based on discussions with, and data provided by, industry representatives, the agencies understand that CLOs issued after section 13 of the Bank Holding Company Act (Volcker Rule) became final contain only loans in the underlying exposures, making them compliant with the loan securitization exemption in the Volcker Rule and implementing regulations. It appears that the CLO market issuance in 2014 has been strong, and the banking organizations that reflect CLO holdings in their investment portfolios report an aggregate net unrealized gain as of December 31, 2013. In addition, the agencies understand that a large number of legacy CLOs consist solely of loans and would be compliant with the Volcker Rule.

The agencies worked closely together to evaluate the implications for banks holding legacy CLOs containing non-loan assets and facing reinvestment period restrictions that would not comply with the Volcker Rule. After this extensive interagency review process, on April 7, 2014, the Federal Reserve Board released a statement announcing the intent to grant two one-year extensions to the Volcker Rule conformance period for certain CLOs, which the agencies believe should address the majority of legacy CLOs that do not comply with the Volcker Rule. The agencies believe that the extended conformance period should allow many of the non-compliant legacy CLOs to mature or otherwise "roll off," such as through investor calls, and should offer investment managers time to potentially change the underlying assets to loans, thereby bringing the CLOs into conformance.

Given the extensive review outlined above; the overall strength of the CLO market; movement in the CLO market to conform further issuances to the Volcker Rule; and the April 7, 2014, statement by the Federal Reserve Board to allow for future extensions of the conformance period through July 21, 2017, we believe that the industry concerns regarding the investment

prohibitions in the Volcker Rule and implementing regulations have been substantially addressed. The definition of "ownership interest" applies to all types of covered funds; therefore, the agencies continue to review the suggestion to clarify the definition of "ownership interest" to fully understand the impact it might have on other types of covered funds.

The agencies continue to review all outstanding issues concerning implementation of the Volcker Rule. Recently, the agencies issued an initial set of six Frequently Asked Questions to provide clarity to the industry in several areas regarding Volcker Rule implementation.

Q2&3 addressed to FRB

Response to questions from the Honorable Patrick E. Murphy
by the Federal Deposit Insurance Corporation

Q1 addressed to CFPB

Q2: (FDIC and NCUA)

Mr. Osterman and Ms. Friend, Operation Chokepoint was designed to go after unlawful short-term lenders. I strongly support efforts to protect Floridians from predatory, illegal lenders. However, I'm hearing from banks that they are dumping legitimate, lawfully operating short-dollar lenders due to reputational risk. While reputational risk is an extremely important consideration for the health and well-being of a financial institution, the consequence of an overly broad reputational risk determination would have the impact of completely putting an end to low-dollar short-term loans. Without access to banking services, the short term, low dollar loan industry is done.

Not only will that undermine the good work that my state has done in regulating this industry, it will assume the authority, given by Congress to CFPB, which is taking a comprehensive, thoughtful approach. If financial regulators, under the guise of reputational risk, assume jurisdiction over short-term loans and effectively eliminate the product, it will cost Floridians both their hard-earned protections and their access to this type of credit.

- **Is the agency intending to cut off banking services from low dollar lenders?**
- **Is the agency intending to shut down payday lending?**
- **If not, how are examiners working to protect institutions from reputational risk without assuming jurisdiction via enforcement and restricting access to short-term credit?**

A2: The FDIC's 2007 *Affordable Small-Dollar Loan Guidelines*[1] and the 2013 *Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products*[2] encourage insured institutions to offer small-dollar loan products that have affordable, reasonable interest rates with no or low fees, and payments that reduce the principal balance of the loan. When structured properly, small-dollar loans can provide a safe and affordable means for borrowers to transition away from reliance on high-cost debt products. A number of banks are currently offering such small-dollar loans to their customers, and the FDIC encourages banks to continue to offer these products, consistent with safety and soundness and other supervisory considerations.

The FDIC's supervisory efforts include raising awareness of the risks that may be associated with third-party payment processors and businesses engaged in higher-risk activities so that

[1] The *Affordable Small Dollar Loan Guidelines* was issued June 19, 2007 via FIL-50-2007, and can be accessed at http://www.fdic.gov/news/news/financial/2007/fil07050.html.
[2] The *Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products* was issued November 21, 2013 and announced through press release PR-105-2013, and can be accessed at http://www.fdic.gov/news/news/press/2013/pr13105.html.

institutions can take appropriate, prudent actions to mitigate such risks. In order to clarify our supervisory approach, the FDIC issued a Financial Institution Letter (FIL) on September 27, 2013 (FIL-43-2013) titled, *FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities,*[3] to banks we supervise to make it clear that the focus of FDIC examinations is to assess whether financial institutions are adequately overseeing activities and transactions that they process and appropriately managing and mitigating potential risks. Examiners conduct reviews to ensure that institutions perform the due diligence and monitoring necessary to mitigate risks presented by these higher-risk relationships. The FIL indicates that financial institutions that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing services to customers operating in compliance with applicable federal and state law. Financial institutions that are operating with the appropriate systems and controls will not be criticized for providing payment processing services to businesses operating with applicable law. Ultimately, it is bank management's decision as to what products and services to offer customers, as long as it does so in a safe and sound manner and in compliance with applicable law.

Q3: (FDIC)

Mr. Osterman, more than 5 years after the financial crisis, proper safeguards are absolutely necessary to preserve the stability of our financial system. As a small business owner, I know and appreciate that regulation carries a cost and that even the best-intended regulatory intentions can have unnecessary, unintended consequences. The biggest banks earned this additional burden, which can be absorbed and budgeted. But for smaller lenders like community banks and credit unions, new compliance costs can be prohibitive. Community banks are hiring, but far too often, they are hiring compliance officers, which do little to pump capital into the community so small businesses can grow and create jobs. Perhaps relatedly, FDIC has only approved deposit insurance for one new bank since 2010, leading some to question whether there is a place for community banks in the twenty-first century.

What is FDIC doing to maintain a proper balance between the actual risk of the smallest institutions and the community banking sector as a whole and a relatively steep regulatory burden?

A3: The Community Banking Study that the FDIC published in December 2012[4] provided a number of insights into community banks' critical role in providing banking services. As defined by the Study, community banks accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.[5] The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community

[3] FIL-43-2013 can be accessed at http://www.fdic.gov/news/news/financial/2013/fil13043.pdf.
[4] The Community Banking Study is available at: http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
[5] The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people and 1,376 rural counties with populations less than 10,000 people.

banks. Without community banks, many rural areas, small towns, and urban neighborhoods would have little or no physical access to mainstream banking services.

The FDIC has implemented a number of initiatives to help community banks understand and comply with new rules and to help address any potential burden. The FDIC's Advisory Committee on Community Banking provides us with advice and guidance on a broad range of policy issues impacting community banks. The Committee, which is composed of community bankers from across the country, has provided valuable input on examination policies and procedures, lending practices, deposit insurance assessments, insurance coverage issues, regulatory compliance matters, and obstacles to the continued growth and ability to extend financial services in their local markets

Additionally, the FDIC has significantly increased the amount of technical assistance and resources available to community banks, several of which are described below.

- The *Directors' Resource Center,*[6] available through the FDIC's website, is dedicated to providing useful information and resources for directors and officers of FDIC-insured institutions.

- In 2013, the FDIC issued a series of 19 in-depth educational videos for directors, officers and employees on supervisory matters. We also published a brochure for bankers on how to receive technical assistance for managing consumer compliance responsibilities.

- Additionally, the FDIC provides technical assistance for significant rulemakings. In 2013, we released a Capital Estimation Tool, developed the Expanded Community Bank Guide, and posted videos on our website to help community banks understand the potential impact of the Regulatory Capital Interim Final Rule.[7]

- Our *Regulatory Calendar,* accessed through the *Directors' Resource Center*, is updated regularly to alert stakeholders to critical information related to changes in federal banking laws and regulations, as well as notices for training opportunities such as banker conference calls.

- In response to banker feedback, the FDIC implemented web-based tools in 2013 that generate more efficient pre-examination information request lists for our Safety and Soundness and Consumer Protection examinations that are tailored to a specific institution's operations and business lines.

- Our Financial Institution Letters providing guidance to the industry highlight the Letters' applicability to banks under $1 billion in asset size so bankers know right away whether it is targeted to their institutions.

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[6] The Directors Resource Center is accessible at: http://www.fdic.gov/regulations/resources/director/.

[7] Technical assistance relative to the capital rules is available at http://www.fdic.gov/regulations/capital/.

- The FDIC Quarterly Banking Profile[8] was recently expanded to include a new section on the performance of community banks to provide a deeper understanding of this important part of the banking industry.

Furthermore, we expect the reforms in the Dodd-Frank Act will do much to promote a more competitive balance between small and large institutions by strengthening the prudential regulatory framework for large systemically important financial companies.

[8] The Quarterly Banking Profile is available at http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.

Response to questions from the Honorable Gwen Moore by the Federal Deposit Insurance Corporation

Q1: (FDIC and FRB)

On September 28, 2014, I was one of several Democrats that wrote Chairman Gruenberg to gain clarification regarding FDIC handling of bank examinations that do business with third-party processors and online non-bank lenders. I would appreciate further explanation of what your agencies are doing to coordinate with the Consumer Financial Protection Bureau to ensure a consistent regulatory regime of these products, given that the CFPB was given jurisdiction for these products under Dodd-Frank. I absolutely support the elimination of bad actors and unscrupulous practices that threaten the safety and soundness of banks, but I continue to believe that it is important for your agencies to work with the CFPB as not to preempt their jurisdiction over these products and to permit them to be lawfully offered consistent with CFPB regulations.

A1: A key priority for the FDIC is ensuring effective coordination and consistent enforcement of laws and regulations with other regulators, including the Consumer Financial Protection Bureau (CFPB). In consultation with the prudential regulators, the CFPB has primary rulewriting and interpretive authority regarding most consumer financial protection laws. The FDIC and the federal prudential regulators have a Memorandum of Understanding in place with the CFPB to coordinate supervisory activities that establishes practices for scheduling examinations, conducting simultaneous examinations, and sharing supervisory information. The FDIC's guidance for banks establishing account relationships with third-party payment processors is focused on risk management principles that banks should follow with respect to these accounts, including effective due diligence and underwriting and ongoing monitoring. The FDIC's examination focus is on assessing whether financial institutions are adequately overseeing activities and transactions that they process and appropriately managing and mitigating risks. Financial institutions that have appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law.

Q2 addressed to FRB and OCC

Response to questions from the Honorable Kyrsten Sinema
by the Federal Deposit Insurance Corporation

Q1: (FDIC and OCC)

It is my understanding that Operation Choke Point is intended to eliminate fraud and illegal transactions from our nation's payment system. However, it has come to my attention that an online lead marketplace based in my district has been forced to lay off employees as a direct result of Operation Choke Point. What is being done to ensure that regulators are effectively eliminating predatory actors who are breaking existing laws and not unintentionally harming legitimate, lawful businesses?

A1: As primary regulator of state-chartered financial institutions that are not members of the Federal Reserve System, the FDIC is responsible for supervising these institutions for safety and soundness and for compliance with consumer protection laws, the Bank Secrecy Act, and information technology requirements.

The FDIC's guidance for banks establishing account relationships with third-party payment processors is focused on risk management principles that banks should follow with respect to these accounts, including effective due diligence and underwriting and ongoing monitoring. The FDIC's examination focus is on assessing whether financial institutions are adequately overseeing activities and transactions that they process and appropriately managing and mitigating risks. Financial institutions that have appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law.

In order to clarify our supervisory approach, the FDIC issued a Financial Institution Letter (FIL) on September 27, 2013 (FIL-43-2013) titled, *FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities,*[1] to banks we supervise to make it clear that the focus of FDIC examinations is to assess whether financial institutions are adequately overseeing activities and transactions they process and appropriately managing and mitigating related risks. The FIL indicates that financial institutions that properly manage these relationships and risks are neither prohibited nor discouraged from providing payment processing services to customers operating in compliance with applicable federal and state law. Financial institutions that are operating with the appropriate systems and controls will not be criticized for providing payment processing services to businesses operating with applicable law. Ultimately, it is bank management's decision as to what products and services to offer customers, as long as it does so in a safe and sound manner and in compliance with applicable law.

Q2 addressed to CFPB

[1] FIL-43-2013 can be accessed at http://www.fdic.gov/news/news/financial/2013/fil13043.pdf.